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• SHAREHOLDER LIABILITY FOR CORPORATE TAXES •

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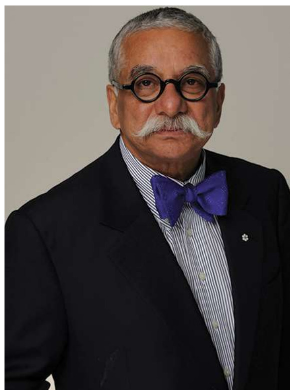

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OVERVIEW

As a general rule, a taxpayer is only responsible for his or her own taxes. There are, however, special rules that apply in the case of non-arm's length transfers of property. An individual who receives property, whether directly or indirectly, in a non-arm's length transaction, can become jointly and severally, or solidarily, liable for the transferor's outstanding taxes as at the date of the transfer if the transfer occurs at less than the fair market value of the property (Section 160). This rule also applies to shareholders who receive dividends from companies with which they do not deal at arm's length.

Section 160 is intended to prevent a taxpayer from rendering himself judgment-proof by transferring his property to, *inter alia*, persons with whom he does not deal at arm's length. Its reach, however, is longer than its intended purpose, and can catch innocent shareholders who receive dividends from a family corporation.

THE RULE IN SUBSECTION 160(1)

Subsection 160(1) is as follows:

> Where a person has, on or after May 1, 1951, transferred property, either directly or indirectly, by means of a trust or by any other means whatever, to
>
> (a) the person's spouse or common-law partner or a person who has since become the person's spouse or common-law partner,

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(b) a person who was under 18 years of age, or

(c) a person with whom the person was not dealing at arm's length,

the following rules apply:

(d) the transferee and transferor are jointly and severally liable to pay a part of the transferor's tax under this Part for each taxation year equal to the amount by which the tax for the year is greater than it would have been if it were not for the operation of sections 74.1 to 75.1 of this Act and section 74 of the *Income Tax Act*, … in respect of any income from, or gain from the disposition of, the property so transferred or property substituted therefor, and

(e) the transferee and transferor are jointly and severally liable to pay under this Act an amount equal to the lesser of

  (i) the amount, if any, by which the fair market value of the property at the time it was transferred exceeds the fair market value at that time of the consideration given for the property, and

  (ii) the total of all amounts each of which is an amount that the transferor is liable to pay under this Act in or in respect of the taxation year in which the property was transferred or any preceding taxation year, but nothing in this subsection shall be deemed to limit the liability of the transferor under any other provision of this Act.

There are four essential conditions for the subsection to apply:

1. There must be a transfer of property.
2. At the time of the transfer, the transferor and the transferee are not at arm's length with each other. For example, the transferee is the transferor's spouse, common-law partner,[1] a person under 18 years of age, or any person with whom the transferor was not dealing at arm's length.[2]
3. The transferor was liable for tax at the time that he, she, or it transferred the property.
4. The fair market value of the property transferred exceeded the fair market value of the consideration that the transferee gave to the transferor at the time of the transfer.[3]

For example, an individual who transfers his family home that he owns outright to his spouse, or common law partner, when he owes taxes to the Canada Revenue Agency ("CRA"), renders the spouse or partner potentially liable for the unpaid taxes, to the extent of any shortfall in consideration on the transfer. The CRA can proceed against the transferee spouse for the shortfall. Even the tax debtor's bankruptcy does not discharge the transferee's liability.[4]

Where the husband and wife jointly own the property (such as the family home), the value of what the wife receives on the transfer is usually reduced by 50 per cent.[5] However, in common law, joint tenancy of property is a form of ownership where two or more persons share equal ownership of their property, and have equal, undivided interests therein. Thus, in effect, each of the joint tenants has 100 per cent ownership of the property. In theory, subsection 160(3.1) would not apply to allocate the proportional interests of joint tenants in these circumstances. Tax courts, which usually interpret the *Income Tax Act*, R.S.C. 1985, c. 1 (5th Supp.) fairly literally, generally overlook this peculiar aspect of the common law of property.

PURPOSE OF RULE

Section 160 is an anti-avoidance provision to prevent taxpayers from divesting assets into friendly hands in order to escape their outstanding taxes.[6] Although the purpose of the rule is to prevent defrauding the Minister by transferring property to non-arm's length parties, the rule is applied strictly without proof of any intention to defraud.[7] Although the rule works reasonably well when the CRA uses it to attack delinquent taxpayers who are attempting to circumvent their outstanding tax liabilities, it can have unexpected consequences for those who do not fully understand its reach.

STRICT LIABILITY

Section 160 is a strict liability provision that applies regardless of any intention on the part of the transferor to avoid taxes.[8] There is no due diligence defense.[9] The provision is not interpreted according to its "object and spirit". The transferee's lack of knowledge of the transferor's tax debt is does not negate liability.[10]

The transferee remains liable even if he, she, or it returns the transferred funds to the transferor, unless the re-transfer of the property is a valid disclaimer of the gift.[11] Indeed, where a corporation confers a benefit on its shareholder under subsection 15(1), both the shareholder and the corporation can be liable for taxes resulting from the transfer.[12]

MEANING OF TRANSFER

"Transfer" is broadly interpreted to include virtually any kind of transaction that involves the passage of property, including gifts, from a person to another. It is immaterial that the parties are acting in good faith at the time that the property is transferred. For example, contributions to a spousal registered retirement savings plan while the transferor owes tax renders the transferee liable, even after the parties' divorce.

"Transfer" includes any divestiture of property from one person to another and includes gifts. In *Fasken Estate*, for example, the courts said:[13]

> the word 'transfer' is not a form of art and has not a technical meaning. It is not necessary to a transfer of property from a husband to his wife that it should be made in any particular form or that it should be made directly. All that is required is that the husband should so deal with the property as to divest himself of it and vest it in his wife, that is to say, pass the property from himself to her. The means by which he accomplishes this result, whether direct or circuitous, may properly be called a transfer.

NON-ARM'S LENGTH

Shareholders in closely-held family corporations, either alone or in conjunction with related family members, usually control the corporation. Hence, they do not usually deal with the corporation at arm's length.[14]

It is a question of fact whether unrelated persons are dealing with each other at arm's length (Section 251(1)(c)). However, the Tax Court of Canada has said that "whether on the facts, there is in law an arm's length relationship is necessarily a question of law".[15]

NO LIMITATION PERIOD

The shareholder's liability for taxes unpaid at the time that the property is transferred may result from a reassessment of the corporation many years later. Because there is no limitation period under section 160 in respect of the liability, the shareholder may remain on the hook indefinitely. Indeed, the shareholder remains liable even after the corporation has been sold or become insolvent.[16]

For example, assume that a corporation declared a $2 million gain as a capital gain in 2010. In 2011, when the corporation is fully paid up on its taxes, it pays a dividend of $100,000 to a passive shareholder, who is "related" to the controlling shareholder. In 2015, the CRA reassesses the corporation and characterizes the gain as business income. The corporation disputes the reassessment for incremental tax, and loses its appeal, by which time it is bankrupt. In these circumstances, the passive shareholder is *personally* liable for the corporation's unpaid taxes if he or she did not provide fair market value in exchange for the dividend in 2011.

However, the normal limitation period for a reassessment under subsection 152(4) begins to run when the CRA issues an assessment under subsection 160(2). Similarly, the 10-year collection limitation period in subsection 222(3) also applies.[17]

THE POWER OF SECTION 160

The combination of the broad interpretation of "transfer", the absence of any due diligence defence, and the unlimited time during which the Minister can assess the recipient for the transferor's tax makes for a powerful anti-avoidance weapon, which the CRA wields, regardless of the *bona fides* of the parties.

CORPORATE LAW OF DIVIDENDS

Dividends on shares represent the yield or income return on invested capital. Corporations may pay dividends in cash, property, or stock to their shareholders. Thus, the essential question is: Do shareholders give fair market consideration in exchange for dividends that they receive?

In corporate law, directors declare dividends at their discretion. The dividends represent the investment yield on shareholder capital. Subsection 24(3) of the *Canada Business Corporations Act* ("*CBCA*")[18] provides as follows:

> Where a corporation has only one class of shares, the rights of the holders thereof are equal in all respects and include the rights
>
> (a) to vote at any meeting of shareholders of the corporation;
>
> (b) to receive any dividend declared by the corporation; and
>
> (c) to receive the remaining property of the corporation on dissolution.

Shareholders do not work for their dividends in the conventional sense of providing labour or services. The investment of their risk capital is sufficient to warrant a return if, as, and when the directors exercise their discretion to pay dividends on the capital stock. In contrast, services are compensated through salary, bonuses, or stock options, which are treated differently for tax purposes.[19]

A shareholder purchases his or her shares for fair market value consideration in exchange for the rights that attach to the shares. Subsection 25(3) of the *CBCA* provides:

> A share shall not be issued until the consideration for the share is fully paid in money or in property or past services that are not less in value than the fair equivalent of the money that the corporation would have received if the share had been issued for money.

Further, a corporation may not add to a stated capital account in respect of any share that it issues an amount greater than the amount of the consideration it receives for the share.

One of these rights is the right to receive the income of the corporation by way of periodic cash distributions in the future or, eventually, through a liquidating distribution. Although the directors of a corporation may not be under any immediate legal obligation to distribute cash dividends in any particular year, they are always under a fiduciary obligation to the corporation. The right of shareholders to ultimately participate in the profits of the corporation is the *raison d'être* of their risk investment in the corporation.

Thus, generally speaking, a shareholder's initial investment in the shares of the corporation can be said to be the consideration that he or she pays for present rights (the right to vote), future rights (the right to a distribution of income as dividends), and distributions of capital on winding-up. The cost of the shares when issued should be equal to their net present value at the time that they are issued by the corporation.

A corporation cannot issue shares for inadequate consideration. The rights, including the right to future dividends, attached to shares are not gifts from the corporation. The payment for the shares is their net present value, as determined at the time of the exchange.

In *Neuman v. Canada (Minister of National Revenue – M.N.R.)*, [1998] S.C.J. No. 37, [1998] 1 S.C.R. 770 at page 791 (S.C.C.), the Supreme Court of Canada, referring with approval to the dissenting reasons of La Forest J. in *McClurg v. Canada*, [1990] S.C.J. No. 134, [1990] 3 S.C.R. 1020 (S.C.C.), confirmed that no consideration can be given for the payment of a dividend:

> a dividend is received by virtue of ownership of the capital stock of a corporation. It is a fundamental principle of corporate law that a dividend is a return on capital which attaches to a share, and is in no way dependent on the conduct of a particular shareholder.

FAIR MARKET VALUE OF DIVIDENDS

The leading case on the definition of "fair market value" is the Federal Court judgment in *Henderson Estate v. Minister of National Revenue*, at page 5476:[20]

> the highest price an asset might reasonably be expected to bring if sold by the owner in the normal method applicable to the asset in question in the ordinary course of business in a market not exposed to any undue stresses and composed of willing buyers and sellers dealing at arm's length and under no compulsion to buy or sell. I would add that the foregoing understanding as I have expressed it in a general way includes what I conceive to be the essential element which is an open and unrestricted market in which the price is hammered out between willing and informed buyers and sellers on the anvil of supply and demand.

The fair market value of property is determined in the hands of the transferor, and is the same in the hands of the transferee.[21]

POTENTIAL LIABILITY OF SHAREHOLDERS

Section 160 is intended to prevent taxpayers from rendering themselves judgment proof through the diversion of assets. Since a corporation is a "person" for tax purposes,[22] the section can extend to *bona fide* passive shareholders of closely-held family corporations in non-arm's length relationships. However, merely being a shareholder, director and officer of a corporation does not necessarily imply that there is a non-arm's-length relationship, unless there are special circumstances to support the conclusion, such as the degree of actual control in fact.[23]

Fournier v. Minister of National Revenue

Prior to the decision of the Tax Court of Canada in *Fournier v. Minister of National Revenue*,[24] subsection 160(1) was generally considered to apply to transfers of property between spouses, and other

members of the family. The provision was seen as one preventing tax debtors from transferring their assets to a spouse, or other relative, and leaving themselves judgment proof.

The provision was not considered to apply to dividends that a corporation might pay to its shareholders. There are other statutory provisions in corporate law that regulate the payment of dividends in circumstances where the paying corporation is unable to meet its financial obligations as they come due.

For example, sections 42 and 118(2) of the *CBCA*, and comparable provincial statues, render the directors of a corporation personally liable for improper payment of dividends. Hence, prior to *Fournier*, there was no reasonable expectation in legal precedents and the jurisprudence to predict the application of the provision to corporate dividends.

Fournier was a ground breaking decision and extended the liability of shareholders for unpaid corporate taxes where the corporation paid dividends to the shareholders at a time when it had outstanding tax obligations. Since *Fournier*, there have been many decisions attaching liability for certain types of dividends that a corporation pays to a shareholder with whom it does not deal at arm's length.[25]

Post 1990 cases also developed the law in respect of payments and dividends to shareholders in various situations involving minority and majority shareholdings, payments to parent corporations, and payments to 50 per cent shareholders. All of this jurisprudence is post *Fournier*.

Even following *Fournier*, there was some doubt as to the scope and reach of subsection 160(1). The courts began to differentiate between situations in which the recipient shareholder was a minority shareholder with no active control or participation in the management of the corporation, and situations where the recipient of the dividend was a majority and controlling shareholder. Then there are cases where a person owns exactly 50 per cent of the shares and does not control the corporation in law, but may, as a question of fact, control the corporation.

Algoa Trust v. Canada[26]

In *Algoa Trust*, the corporation, had satisfied all of its income tax assessments for its 1975 to 1981 taxation years. In 1982, Algoa Trust paid a cash dividend to one of its corporate shareholders, and a stock dividend to another corporate shareholder. Later, however, Revenue Canada (as it was then called) reassessed the corporation in respect of its 1979, 1980 and 1981 taxation years. When the corporation failed to pay its tax, the Minister sought to recover the tax from its shareholders under section 160.

The tax court determined that shareholders do not provide any consideration for their dividends. However, the payment of a dividend is a transfer of property. Mr. Justice Rip of the Tax Court of Canada stated (at p. 2304):[27]

> The payment of a dividend in money or other property is a transfer of property within the meaning of subsection 160(1) of the Act. The corporation is impoverished and its shareholders are enriched. I fail to see the reason why a dividend is not a transfer of property. I do realize an unknowing shareholder not dealing at arm's length with the corporation may become jointly and severally liable under the Act for the liability of the corporation as a result of my interpretation of subsection 160(1). If this is an unintended effect of that provision — and I am not sure it is — Parliament surely will consider remedying the problem.

The Court also held that the payment of a stock dividend was not a transfer of property.

However, in Views Doc No. 2011-0412201C6, the CRA takes the position that Algoa does not constitute authority for the proposition that subsection 160(1) is inapplicable to the payment of a stock dividend. The CRA's view is that the expression "transferred property" in subsection 160(1) must be interpreted in a broad sense and can be applied to situations where multiple steps are taken to transfer property.

The value of a transfer in respect of a dividend for purposes of subsection 160(1) is the actual amount of the dividend, rather than the net after-tax amount of the dividend.[28]

Subsection 160(1) can also apply to a capital dividend,[29] or where the dividend recipient is a corporation.[30]

Dividends in Exchange for Services

In *Davis v. Canada*,[31] the Tax Court held that dividends could be paid in exchange for services rendered, or to be rendered, which could count as consideration. The taxpayers' accountant testified that there were tax advantages [lower rates] in compensating the shareholders for their work by paying dividends instead of salary, and that it was the custom of his office to declare the dividend at the *beginning* of the fiscal year, in anticipation of the services that the shareholders *would render later in the year*. Relying on dicta in *McClurg v. Canada*,[32] the court accepted Mrs. Davis' testimony that she gave adequate consideration in services in exchange for the dividend. The court considered the services to be legitimate *quid pro quo.* Therefore, there was no shortfall of consideration, and section 160 did not apply.

Davis appears to extend the principles of corporate law in holding that a corporation may pay dividends to non-arm's length shareholders as legitimate *quid pro quo*. Dividends paid to passive shareholders who do not provide *quid pro quo* of services, or other contributions, remain at risk for unpaid corporate taxes if the corporation is unable to meet its obligations to the fisc.

LOANS

A loan can be consideration for the purposes of subsection 160(1). However, the burden, as always, is on the taxpayer to prove the existence of the loan. This is best done through contemporaneously prepared records in writing that show the terms of the loan, or receipts.

ATTRIBUTED INCOME

Where a person transfers property to another in circumstances when the attribution rules apply,[33] the transferee is liable for the transferor's tax on any income of the transferee that is attributed to the transferor.[34] The attribution rules in sections 74.1 to 74.5 apply with respect to outstanding loans of property.

LIABILITY BEFORE ASSESSMENT

The CRA's position is that a transferee may be liable under section 160 even if the transferor has not yet been assessed (*i.e.*, the CRA considers the transfer of property to trigger the liability under section 160); Views Doc No. 2008-0300311I7. The CRA's position is supported by *Ingrao v. Minister of National Revenue*, [1989] 1 C.T.C. 2052, 89 D.T.C. (T.C.C.), in which the Court stated (para. 15):

> I am not persuaded that subparagraph 160(1)(e)(ii) looks to liability to pay on the date of assessment. The statute as reworded clearly discloses a legislative intent to impose liability on the transferee in respect of the year in which the transfer takes place. The time when the assessment happens to take place is a consideration irrelevant to the statutory scheme. It is the transfer that triggers liability.

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[2] *Income Tax Act*, R.S.C. 1985, c. 1 (5th Supp.), s. 251 and ss. 251(2)–(6) on the meaning of "related".

[3] See *Livingston v. Canada*, [2008] F.C.J. No. 360, [2008] 3 C.T.C. 230 (C.A.), and *Hardtke v. Canada*, [2015] T.C.J. No. 109, 2015 TCC 135.

[4] *Heavyside v. Canada*, [1996] F.C.J. No. 1608, [1997] 2 C.T.C. 1 (C.A.); *Bleau v. Canada*, [2007] F.C.J. No. 209, 2007 FCA 61.

[5] *Income Tax Act*, R.S.C. 1985, c. 1 (5th Supp.), subs. 160(3.1).

[6] *Medland v. R.*, [1998] F.C.J. No. 708, [1999] 4 C.T.C. 293 (FCA). See also: *Algoa Trust v. R.*, (*sub nom. Algoa Trust v. Canada*), [1993] T.C.J. No. 15, [1993] 1 C.T.C. 2294, 93 D.T.C. 405 (T.C.C.); *Charrier v. Minister of National Revenue*, [1988] T.C.J. No. 735, 89 D.T.C. 104, (T.C.C.); *Fasken Estate v. Minister of National Revenue*, (*sub nom. Fasken v. Minister of National Revenue*), [1948] Ex. C.J. No. 17, [1948] Ex. C.R. 580, 49 D.T.C. 491, [1948] C.T.C. 265, [1949] 1 D.L.R. 810; *Jones v. Skinner* (1835), 5 L.J. Ch. 87 (Eng. Ch.); *Kieboom v. Canada (Minister of National Revenue – M.N.R.)*, [1992] F.C.J. No. 605, [1992] 2 C.T.C. 59, 46 E.T.R. 229 (C.A.), (*sub nom. Canada v. Kieboom*) [1992] 3 F.C. 488, (*sub nom. Minister of National Revenue v. Kieboom*) 145 N.R. 360, (*sub nom. Minister of National Revenue v. Kieboom*) 57 F.T.R. 11 (note) (C.A.).

[7] See, for example, *Montreuil v. Canada*, [1994] T.C.J. No. 418, [1996] 1 C.T.C. 2182 (T.C.C.).

[8] *Montreuil v. Canada*, [1994] T.C.J. No. 418, [1996] 1 C.T.C. 2182 (T.C.C.).

[9] See *Wannan v. Canada*, [2003] F.C.J. No. 1693, [2004] 1 C.T.C. 326 (C.A.) and *Waugh v. Canada*, [2008] F.C.J. No. 669, 2008 FCA 152. In *Algoa Trust v. Canada*, [1993] T.C.J. No. 15, [1993] 1 C.T.C. 2294, 93 D.T.C. 405 (T.C.C.), Rip T.C.J. said at page 2302 (D.T.C. 411):

> The purpose of section 160 is to foil an attempt by a taxpayer who is liable to pay any amount under the Act to avoid the fisc by transferring property otherwise available to satisfy the liability to one of three groups of persons, including a person with whom he or she was not dealing at arm's length.

[10] *Reagh v. Canada*, [2004] T.C.J. No. 187, 3 C.T.C. 2336 (T.C.C.).

[11] *Leclair v. Canada*, [2011] T.C.J. No. 357, 2011 D.T.C. 1328 (T.C.C.).

[12] See, for example, *Bleau v. Canada*, [2007] F.C.J. No. 209, 2007 FCA 61, where an appropriated amount, and a loan, were added to the shareholder's income under subsections 15(1) and (2) respectively.

[13] *Fasken Estate v. Minister of National Revenue*, [1948] Ex. C.J. No. 17, [1948] C.T.C. 265 at 279, 49 D.T.C. 491 at 497; see also *St. Aubyn v. A.G.*, [1952] A.C. 15 at 53 (H.L.), *per* Lord Radcliffe.

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[17] See *Duchaine v. Canada*, [2015] T.C.J. No. 195, 2015 TCC 245.

[18] R.S.C. 1985, c. C-44.

[19] *Neuman v. Canada (Minister of National Revenue – M.N.R.)*, [1998] S.C.J. No. 37, [1998] 3 C.T.C. 177 (S.C.C.).

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[22] *Income Tax Act*, R.S.C. 1985, c. 1 (5th Supp.), s. 248(1) "person".

[23] See: *Gestion Yvan Drouin Inc. v. Canada*, [2000] T.C.J. No. 872, [2001] 2 C.T.C. 2315 at para. 92 (T.C.C.).

[24] [1991] T.C.J. No. 7, 91 D.T.C. 746 (T.C.C.).

[25] See, for example, *2753-1359 Québec Inc. v. Larouche*, [2010] F.C.J. No. 83, [2010] 4 C.T.C. 202 (C.A.) and *Algoa Trust v. Canada*, [1993] T.C.J. No. 15, [1993] 1 C.T.C. 2294 (T.C.C.).

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[28] *Gilbert v. Canada*, [2007] F.C.J. No. 483, 2007 FCA 136, leave to appeal refused [2007] C.S.C.R. No. 274.

[29] *Neumann v. Canada*, [2009] T.C.J. No. 67, [2009] 4 C.T.C. 2205 (T.C.C.).

[30] *Pomerleau Inc. v. Canada*, [2008] T.C.J. No. 439, 2009 D.T.C. 1208 (T.C.C.); *Mario Côté Inc. v. Canada*, [2011] T.C.J. No. 73, [2011] 5 C.T.C. 2133 (T.C.C.).

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[33] *Income Tax Act*, R.S.C. 1985, c. 1 (5th Supp.), ss. 74.1–75.1.

[34] *Income Tax Act*, R.S.C. 1985, c. 1 (5th Supp.), s. 160(1)(d).