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NEUMAN AND BEYOND: INCOME SPLITTING, TAX AVOIDANCE, AND STATUTORY INTERPRETATION IN THE SUPREME COURT OF CANADA

*David G. Duff**

I. INTRODUCTION

Under a progressive income tax such as that in Canada, where tax applies to the income received by individuals rather than aggregate amounts received by spouses or larger family units, taxpayers have an incentive to shift income to lower-income spouses or children, thereby minimizing the amount of income subject to tax at higher marginal rates of tax and maximizing the availability of personal exemptions that exclude a minimum amount of income from tax altogether.¹ Though an income tax might reasonably respect some or all of these transfers, basing tax on each individual's

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1. The federal rates appear in s. 117(2) of the Income Tax Act, R.S.C. 1985, c. 1 (5th Supp.) (as amended) (hereafter the "ITA"), and are currently 17% of the first \$29,590 of taxable income, 26% of the next \$29,590 of taxable income, and 29% of taxable income exceeding \$59,180. Provincial taxes, as well as federal and provincial surtaxes, add to the progressivity of this rate structure. Personal exemptions appear in s. 118(1) of the ITA, which provides a credit against federal tax payable equal to 17% of \$6,794 (\$1,555) in the case of an individual taxpayer, a further credit up to 17% of \$5,718 (\$972) for taxpayers supporting a cohabiting spouse or wholly dependent person, and a separate credit equal to 17% of \$6,456 for each adult who is dependent on the taxpayer because of mental or physical infirmity. Since the additional credits for spouses and wholly dependent persons are less than the amount of the single credit, and there is no general credit for dependent children, the aggregate value of these personal exemptions can be maximized by ensuring that the annual income of each family member is at least \$6,794. With the combined effect of the dividend gross-up and tax credit in s. 82(1)(b) and s. 121, moreover, individuals can receive up to \$26,640 of taxable dividends without paying tax.

legal entitlement to income received,² the Canadian tax system has generally opposed such income splitting, attributing income from property transferred to a spouse or minor child back to the taxpayer from whom the property is transferred,³ and taxing transfers of property under Gift and Estate Taxes imposed at the federal level prior to 1972.⁴

Among the various rules attributing amounts received by one taxpayer to another is s. 56(2) of the *Income Tax Act*, according to which:

A payment or transfer of property made pursuant to the direction of, or with the concurrence of, a taxpayer to some other person for the benefit of the taxpayer or as a benefit that the taxpayer desired to have conferred on the other person . . . shall be included in computing the taxpayer's income to the

2. See, e.g., Peter W. Hogg and Joanne E. Magee, *Principles of Canadian Income Tax Law* (Scarborough: Carswell, 1995) at p. 103, suggesting that:

It is arguable . . . that the logic of accepting the individual as the tax unit should be carried forward to the elimination of the attribution rules. After all, the tax saving caused by income splitting is purchased at the price of a legal divestment of the income-earning property in favour of another individual. It is true that the transferee is, we are assuming, a member of the transferor's family, but if the arguments in favour of the individual as the tax unit are valid, it is not silly to treat the transferor's loss of legal title to and control over income as having tax consequences. Moreover, the repeal of the attribution rules would provide an incentive to property-owners to share their property with spouses and children, which might contribute in some small way to a more equitable distribution of wealth, especially to women, who often lack the same opportunity to accumulate wealth as men.

3. See s. 74.1(1) and (2) of the ITA, which deem any income or loss from property transferred or loaned to a spouse or minor child or property substituted therefor to be that of the transferor or lender and not that of the recipient. See also s. 248(5)(a), which deems property substituted for substituted property to be substituted property, the attribution rule for capital gains and losses on property transferred or loaned to a spouse in s. 74.2, and s. 75.1 which applies to certain transfers of farm property to a minor child. The first attribution rule appeared in s. 4(4) of the *Income War Tax Act*, S.C. 1917, c. 28, according to which:

A person who, after the first day of August, 1917, has reduced his income by the transfer or assignment of any real or personal, movable or immovable property, to such person's wife or husband, as the case may be, or to any member of the family of such person, shall, nevertheless, be liable to be taxed as if such transfer or assignment had not been made, unless the Minister is satisfied that such transfer or assignment was not made for the purpose of evading the taxes imposed under this Act or any part thereof.

4. See Part IV of the *Income Tax Act*, R.S.C. 1952, c. 148; and *Estate Tax Act*, R.S.C. 1970, c. E-9. When the Gift Tax was first introduced in 1935, the Minister of Finance explained that the tax was being imposed "primarily to operate as a deterrent to transfers of property by gift, chiefly within family groups which would have the effect of reducing personal income to lower brackets and thus securing income tax assessment at rates lower than would otherwise be applicable". See *House of Commons Debates* (1935), vol. 2, p. 1986.

extent that it would be if the payment or transfer had been made to the taxpayer.

This rule, originally enacted as s. 16(1) of the 1948 *Income Tax Act*,⁵ attempts to prevent the diversion of income by a taxpayer to another person, either for the taxpayer's benefit or the benefit of that other person, by including the amount paid or transferred to the other person "to the extent that it would be if the payment or transfer had been made to the taxpayer". In this respect, as courts and commentators have noted, it codifies a doctrine of indirect or constructive receipt according to which an amount that would be included in a taxpayer's income if received by the taxpayer is taxable to the taxpayer if it is diverted to another person for the taxpayer's benefit or the benefit of that other person.⁶

5. S.C. 1948, c. 52.

6. See, e.g., *Miller v. M.N.R.*, [1962] C.T.C. 199 at p. 212, 62 D.T.C. 1139 (Exch. Ct.), in which Thurlow J. (as he then was) stated of then s. 16(1) that it "is intended to cover cases where a taxpayer seeks to avoid receipt of what in his hands would be income by arranging to have the amount received by some other person whom he wishes to benefit or by some other person for his own benefit"; *M.N.R. v. Bronfman*, [1965] C.T.C. 378 at p. 384, 65 D.T.C. 5235 (Exch. Ct.), in which Dumoulin J. emphasized that "the section's clear enough purpose is the taxation of indirect payments"; *Outerbridge Estate v. Canada*, [1991] 1 C.T.C. 113 at pp. 116-17, 90 D.T.C. 6681 (F.C.A.), in which Marceau J.A. observed that "the provision . . . is rooted in the doctrine of 'constructive receipt' and was meant to cover principally cases where a taxpayer seeks to avoid receipt of what in his hands would be income by arranging to have the amount paid to some other person either for his own benefit (for example, the extinction of a liability) or for the benefit of that other person", and *McClurg v. M.N.R.*, [1991] 1 C.T.C. 169 at pp. 183-84, 91 D.T.C. 5001 (S.C.C.), in which Dickson C.J.C. commented that the provision "is designed to prevent avoidance by the taxpayer, through the direction to a third party, of receipts which he or she otherwise would have obtained". For useful commentaries on s. 56(2) and its predecessor s. 16(1), see Brian Arnold, *Timing and Income Taxation: The Principles of Income Measurement for Tax Purposes* (Toronto: Canadian Tax Foundation, 1983) at pp. 87-90, emphasizing the provision's origins in the doctrine of "indirect receipt" according to which an amount that would be included in a taxpayer's income if directly received by the taxpayer is taxable to the taxpayer if it is applied by the taxpayer for the taxpayer's benefit or at the taxpayer's direction, and William I. Innes, "The Taxation of Indirect Benefits: An Examination of ss. 56(2), 56(3), 56(4), 245(2), and 245(3) of the Income Tax Act" in *Report of the Proceedings of the Thirty-Eighth Tax Conference*, 1986 Conference Report (Toronto: Canadian Tax Foundation, 1987), 42:1-36 at p. 12, observing that "s. 56(2) adds a novel dimension to the concept of agency or constructive receipt" by applying "where the taxpayer desired to confer a benefit upon a third party" and concluding that: "Parliament seems to have concluded, probably correctly, that the satisfaction of such moral obligations does not fall within the common law principles of agency or constructive receipt. Accordingly, Parliament perceived the need for a statutory extension of such principles and embodied it in the predecessor to s. 56(2), first enacted in 1948."

In recent years, taxpayers have tested the scope of this anti-avoidance rule through corporate share capital structures authorizing the payment of discretionary dividends on classes of shares typically held by lower-income spouses and children.⁷ In *McClurg v. M.N.R.*,⁸ a majority of the Supreme Court of Canada sanctioned discretionary dividend clauses as valid under corporate law, but granted only qualified approval of the use of discretionary dividends for tax purposes.⁹ In *Neuman v. M.N.R.*,¹⁰ however, the court removed any such qualification, opening the door to these share structures as an effective means of splitting income with spouses or children. Although the 1999 Federal Budget proposes to preclude these structures for splitting income with minor children by introducing a special "income-splitting tax",¹¹ discretionary dividends may still be used to split income with a lower-income spouse.

This comment examines the Supreme Court of Canada decision in *Neuman*, considering the grounds of the decision itself as well as its implications for income splitting, tax avoidance, and the manner in which the Supreme Court of Canada interprets the *Income Tax Act*. Part II reviews the facts of the case, its judicial history, and the decision reached by the Supreme Court of Canada. Part III evaluates this decision in light of the text of s. 56(2), the purpose of this provision, and the practical consequences of the court's interpretation. Part IV considers the implications of the decision and subsequent legislative amendments for income splitting, tax avoidance, and statutory interpretation. Part V offers brief conclusions.

II. NEUMAN

In *Neuman*, the taxpayer, Melville Neuman, a lawyer practicing with a Winnipeg firm, established a holding company to which

7. For early cases in which s. 56(2) was held to apply to the payment of discretionary dividends, see *Titeley v. M.N.R.*, [1977] C.T.C. 2045, 77 D.T.C. 36 (T.R.B.); *Champ v. The Queen*, [1983] C.T.C. 1 (F.C.T.D.); and *Cliche v. M.N.R.*, [1986] 2 C.T.C. 2114, 86 D.T.C. 1571 (T.C.C.). These cases are reviewed in Donald N. Cherniawsky and Marvin L. Toy, "Income Splitting" in *Report of the Proceedings of the Forty-Eighth Tax Conference*, 1996 Conference Report (Toronto: Canadian Tax Foundation, 1997), 52:1-70 at pp. 18-21.

8. *Supra*, footnote 6.

9. The decision in *McClurg* is examined in Parts II and III of this article.

10. [1998] 3 C.T.C. 177 (S.C.C.).

11. See Hon. Paul Martin, *The Budget Plan 1999* (Ottawa: Department of Finance, February 16, 1999), Annex 7 at pp. 193-94 and 238-39, proposing to apply the top marginal rate of tax to taxable dividends of private companies (as well as certain other amounts) received by a minor child.

dividends were paid by the firm's management company and from which dividends were subsequently paid both to the taxpayer and to his wife Ruby. The Minister applied s. 56(2) to attribute to the taxpayer the dividends paid to his wife.

1. Facts

On April 29, 1981, the taxpayer incorporated Melru Ventures Inc. ("Melru") as a family holding company. According to the articles of incorporation:

(a) the holders of Class "G" shares shall in each year, in the discretion of the directors, be entitled out of any or all profits or surplus available for dividend to non-cumulative dividends at such rate as may from time to time be declared on any such shares but not exceeding the equivalent of 1% per annum on "redemption price" above the maximum prime bank rates . . .

.....

(e) all dividends paid or declared and set aside for payment in any fiscal year, after making payments on Class "G" shares and preference shares of dividends declared shall be paid firstly on Class "F" shares until dividends aggregating 1¢ per share on the Class "F" shares then outstanding have been paid and then any additional dividends shall be set aside for payment on common shares until the common shares then outstanding shall have received 1¢ per share and any additional dividends shall be paid on Class "F" shares until they receive that fraction of profits properly available for payment of dividends as the number of Class "F" shares then outstanding bear to the total number of Class "F" shares and common shares then outstanding and the balance shall in the discretion of the directors be paid on common shares or set aside for future payment on common shares at the discretion of the board of directors.

As a result, dividends could be declared at the sole discretion of the directors, and distributed selectively among the various classes of shares.

On the same day that he incorporated Melru, the taxpayer transferred to it on a tax-deferred basis under s. 85(1) of the *Income Tax Act* the 1,285,714 shares he held in the firm's management company, Newmac Services (1973) Ltd. ("Newmac"), the fair market value of which was reported to be \$120,000, receiving in exchange 1,285,714 voting Class "G" shares of Melru. At a meeting of the first director on May 1, 1981, the taxpayer was appointed President of Melru, his wife Ruby was appointed Secretary and 1 common voting share of Melru was issued to the taxpayer for \$1. Later that day, 99 non-voting Class "F" shares of Melru were issued to Mrs. Neuman at a price of \$1 per share.

At the first annual meeting of Melru shareholders on August 12, 1982, Mrs. Neuman was elected sole director, replacing her husband. Later that day, a meeting of the board of directors confirmed Mr Neuman as President of Melru and Mrs. Neuman as Secretary.

A month later, on September 8, 1982, another meeting of the Melru board of directors was held. Having received \$20,000 in dividends from Newmac, Mrs. Neuman as sole director of Melru declared a dividend of \$5,000 on the Class "G" shares and \$14,800 on the Class "F" shares. According to the minutes of the meeting, the holder of the common shares (*i.e.*, the taxpayer) indicated that he was prepared to have money set aside for future payment on his common shares. All decisions of the board were subsequently confirmed by a unanimous resolution at a meeting of Melru shareholders held on October 12, 1983.

Upon receiving the dividends, Mrs. Neuman immediately loaned the \$14,800 to the taxpayer, receiving a demand promissory note as security. Mrs. Neuman died in 1988 and the loan was never repaid. By notice dated October 1, 1984, the Minister reassessed the taxpayer under s. 56(2), including in his income for his 1982 taxation year the \$14,800 of dividends received by Mrs. Neuman from Melru.

2. Judicial History

In the Tax Court of Canada, Sarchuk T.C.C.J. allowed the taxpayer's appeal, citing Dickson C.J.C.'s majority decision in *McClurg*, which held, as a general rule, that s. 56(2) does not apply to the declaration of dividends.¹² In the Federal Court, Trial Division, Rothstein J. applied this general rule as well, dismissing the Minister's appeal from the Tax Court decision on the grounds that s. 56(2) "is not designed to prevent . . . income splitting in the context of the director-shareholder relationship and the declaration of dividends".¹³

The Federal Court of Appeal allowed the Minister's appeal and upheld the reassessment including in the taxpayer's income for his 1982 taxation year the Melru dividends received by his wife

12. *Neuman v. M.N.R.*, [1992] 2 C.T.C. 2074, 92 D.T.C. 1652 (T.C.C.). The decision in *McClurg* is examined later in Part II and in Part III.

13. *R. v. Neuman*, [1994] 1 C.T.C. 354, 94 D.T.C. 6094 at p. 6102 (F.C.T.D.).

Ruby.¹⁴ According to Isaac C.J. (Stone and McDonald JJ.A., concurring) the payment satisfied each of the four elements necessary to the application of s. 56(2): (1) there was a payment or transfer of property (the dividends) to a person other than the taxpayer (Mrs. Neuman);¹⁵ (2) the payment or transfer was made at the direction of or with the concurrence of the taxpayer;¹⁶ (3) the payment was for the taxpayer's benefit or as a benefit that the taxpayer desired to confer on the recipient,¹⁷ and (4) the payment or transfer would have been included in computing the taxpayer's income if it had been received by him instead of his wife.¹⁸

As for Dickson C.J.C.'s decision in *McClurg*, Isaac C.J. observed that the general rule according to which s. 56(2) does not apply to the payment of a dividend was qualified by other passages in that decision emphasizing the "economic and commercial reality of the taxpayer's transactions",¹⁹ the recipient's "very real contributions, financial and operational" to the company,²⁰ and the fact that the dividend payments in that case "represented a legitimate *quid pro quo* and were not simply an attempt to avoid the payment of taxes".²¹ In *Neuman*, on the other hand:

. . . the learned Trial Judge found that Melru was incorporated for tax planning and income splitting purposes and had no other independent business purpose,

14. *Neuman v. M.N.R.*, [1996] 3 C.T.C. 270, 96 D.T.C. 6464 (F.C.A.).

15. *Ibid.*, at p. 287, citing *Champ v. The Queen*, *supra*, footnote 7.

16. *Ibid.*, at p. 288, holding "on the balance of probabilities that the dividend of \$14,800 was declared to Ruby Neuman with the *concurrence* of the respondent", and emphasizing that "s. 56(2) does not require proof that the transfer of property be both at the direction of and with the concurrence of the taxpayer".

17. *Ibid.*, at p. 288, observing that the taxpayer benefited from the payment of the dividend in two ways: "by splitting the dividend from Newmac in the way that he did, he reduced the amount of income tax he would otherwise have paid and, furthermore, he enjoyed the use of the full amount of the dividend which his wife had received". To the extent that the first of these "benefits" ignores the separate legal status of Mr and Mrs. Neuman, while the second ignores the character of the loanback as a separate transaction, the court's characterization of the payment as a benefit to Mr Neuman is questionable. Even if these factors are taken into account, however, it is arguable that the payment was a benefit that Mr Neuman desired to confer on Mrs. Neuman. See the analysis of the benefit requirement, *infra*, text accompanying footnotes 108-114.

18. *Ibid.*, concluding that "the appellant has also satisfied this element, since, by the conjoint operation of sections 12(1)(j) and 82(1) of the Act, the dividend which Ruby Neuman received would have been included in the respondent's income for the 1982 taxation [year], if it had not been paid to her".

19. *McClurg*, *supra*, footnote 6, at p. 183.

20. *Ibid.*, at p. 185.

21. *Ibid.*

that the amount of dividends declared were arbitrary and that Ruby Neuman made no contribution to Melru and did not assume any risks for the company.²²

In addition, Isaac C.J. explained, the decision in *McClurg* had mentioned a possible distinction in the application of s. 56(2) between arm's length and non-arm's length transactions, suggesting that the provision "may be applicable" to "the exercise of a discretionary power to distribute dividends when the non-arm's length shareholder has made no contribution to the company".²³ In light of this statement and the different factual circumstances in *Neuman*, the Federal Court of Appeal held that "s. 56(2) has application to the facts of this case and that the Minister was right in including the dividends which Ruby Neuman received from Melru in the income of the respondent for the 1982 taxation year".²⁴

3. Supreme Court of Canada Decision

In the Supreme Court of Canada, Iacobucci J., writing for a unanimous panel of seven judges, allowed the taxpayer's appeal. Explaining that "the interpretation of this Court's majority decision in *McClurg* lies at the heart of the present case",²⁵ Iacobucci J. began by stating that "A large part of my analysis will involve a review of the holdings in *McClurg*."²⁶ Before examining *McClurg*, however, the judgment makes a number of general observations "to place the present debate into its proper perspective".²⁷

(a) General Observations

First, Iacobucci J. noted, while s. 56(2) "strives to prevent tax avoidance through income splitting", this provision is "a specific tax avoidance provision and not a general provision against income splitting".²⁸ Indeed, he emphasized, since the ITA contains "no general scheme to prevent income splitting",²⁹ s. 56(2) "can only

22. *Neuman v. M.N.R.*, *supra*, footnote 14, at p. 290.

23. *McClurg*, *supra*, footnote 6, at p. 185.

24. *Neuman v. M.N.R.*, *supra*, footnote 14, at p. 294.

25. *Neuman*, *supra*, footnote 10, at p. 186.

26. *Ibid.*, at p. 187.

27. *Ibid.*

28. *Ibid.*

29. *Ibid.*, citing Vern Krishna and J. Anthony VanDuzer, "Corporate Share Capital Structures and Income Splitting: *McClurg v. Canada*" (1992-93), 21 C.B.L.J. 335 at p. 367.

operate to prevent income splitting where the four preconditions to its application are specifically met".³⁰

Second, Iacobucci J. observed, "this case concerns income received by Ruby Neuman during the 1982 taxation year at which time the ITA did not provide specific guidelines to deal with corporate structures designed for the purposes of income splitting and tax minimization".³¹ Although corporate income splitting is now subject to a special attribution rule in s. 74.4,³² this provision was introduced as part of a general revision of the attribution rules in 1985,³³ and did not apply to the transactions in *Neuman* which occurred in 1981 and 1982.

Third, he added, "this appeal is limited to the interpretation and application of s. 56(2) of the ITA; the appeal is not based on the general anti-avoidance rule set out in s. 245 of the ITA ("GAAR")".³⁴ The GAAR, as Iacobucci J. noted, came into force on September 13, 1988 and applies only to transactions entered into on or after that date.³⁵

Fourth, he explained, "the respondent has not argued that the appellant was involved in a sham or an artificial transaction".³⁶ Although the fact that Mrs. Neuman loaned the amount of the

30. *Ibid.*

31. *Ibid.*

32. This provision deems individuals who transfer or loan property to a corporation other than a "small business corporation" to have received interest computed at a prescribed rate on the outstanding amount of the loan or transferred property, where "one of the main purposes of the transfer or loan may reasonably be considered to be to reduce the income of the individual and to benefit" a spouse or related minor owning not less than 10% of the issued shares of any class of the capital stock of the corporation. Given the finding of the trial judge that Melru was incorporated for tax planning and income-splitting purposes and had no other independent business purpose, and the fact that Mrs. Neuman held all of the Class "F" shares, it follows that s. 74.4 could have applied to the transactions in *Neuman* had the provision existed in 1981 and 1982.

33. S.C. 1986, c. 6, s. 38, applicable with respect to loans and transfers of property made after November 21, 1985. For a thorough review of the revised attribution rules, see Claire F.L. Young, "The Attribution Rules: Their Uncertain Future in Light of Current Problems" (1987), 35 Can. Tax J. 275.

34. *Ibid.*

35. S.C. 1988, c. 55, s. 185, applicable with respect to transactions entered into on or after September 13, 1988. For an excellent explanation of the general anti-avoidance rule, see Brian J. Arnold and James R. Wilson, "The General Anti-Avoidance Rule - Parts I, II and III" (1988), 36 Can. Tax J. 829, 1123 and 1369. For a more recent review, see John R. Owen, "Statutory Interpretation and the General Anti-Avoidance Rule: A Practitioner's Perspective" (1998), 46 Can. Tax J. 233.

36. *Ibid.*

dividends back to Mr Neuman interest-free immediately after receiving the dividends might have suggested the possibility of a "sham" in which "acts done or documents executed . . . are intended . . . to give to third parties . . . the appearance of creating . . . legal rights and obligations different from the actual legal rights and obligations (if any) which the parties intend to create";³⁷ the Minister apparently concluded that the legal rights and obligations actually created by Mr and Mrs. Neuman were consistent with their documentation, namely the payment of a dividend to Mrs. Neuman and the transfer of these funds to Mr Neuman by way of an interest-free demand loan secured by a promissory note. As for the question of "artificiality", which relates to the anti-avoidance rule in former s. 245(1),³⁸ it is unlikely that it could have applied to the transactions in *Neuman*, since they did not result in any "deduction . . . in respect of a disbursement or expense made or incurred" even if they might have reduced the taxpayer's income "unduly or artificially".³⁹

Finally, Iacobucci J. emphasized, "it is important to remember that this Court held unanimously in *Stuart* . . . that a transaction should not be disregarded for tax purposes because it has no

37. See *Snook v. London & West Riding Investments Ltd.*, [1967] 1 All E.R. 518 at p. 528 (C.A.) per Lord Diplock, cited with approval in *M.N.R. v. Cameron*, [1972] C.T.C. 380, 72 D.T.C. 6325 (S.C.C.). See also *Stuart Investments Ltd. v. The Queen*, [1984] C.T.C. 294 at p. 313, 84 D.T.C. 6305 (S.C.C.), where Estey J. characterized a "sham" as a situation in which: "The transaction and the form in which it was cast by the parties and their legal and accounting advisers [can] be said to have been so constructed as to create a false impression in the eyes of a third party, specifically the taxing authority". The Supreme Court of Canada has reaffirmed this definition on several occasions: *McClurg*, *supra*, footnote 6, at p. 183; *Antosko v. The Queen*, [1994] 2 C.T.C. 25, 94 D.T.C. 6314 (S.C.C.) at p. 30; and *Continental Bank Leasing v. Canada*, [1998] 2 S.C.R. 298. According to the sham doctrine, the tax consequences of a transaction are to be determined according to the legal rights and obligations actually created by the parties to the transaction, not apparent rights and obligations reflected in acts or documents intended to create a different impression in the eyes of third parties. For applications of the sham doctrine in Canadian tax law, see *M.N.R. v. Shields*, [1962] C.T.C. 548, 62 D.T.C. 1343 (Exch. Ct.); *Susan Hosbery v. M.N.R.*, [1969] C.T.C. 533, 69 D.T.C. 5346 (Exch. Ct.); and *Dominion Bridge Company Ltd. v. The Queen*, [1975] C.T.C. 263, 75 D.T.C. 5150 (F.C.T.D.), affd [1977] C.T.C. 554, 77 D.T.C. 5367 (F.C.A.).

38. According to this provision, the Minister could disallow any "deduction . . . in respect of a disbursement or expense made or incurred in respect of a transaction or operation that, if allowed, would unduly or artificially reduce [a taxpayer's] income".

39. For applications of this provision and its predecessors, see *Shulman v. M.N.R.*, [1961] C.T.C. 385, 61 D.T.C. 1213 (Exch. Ct.); *Don Fell Ltd. v. The Queen*, [1981] C.T.C. 363, 81 D.T.C. 5282 (F.C.T.D.); *Fording Coal v. The Queen*, [1996] 1 C.T.C. 230, 95 D.T.C. 5672 (F.C.A.), and *Central Supply Co. (1972) Ltd. v. The Queen*, [1997] 3 C.T.C. 102 (F.C.A.).

independent or *bona fide* business purpose".⁴⁰ On the contrary, he affirmed, "taxpayers can arrange their affairs in a particular way for the sole purpose of deliberately availing themselves of tax reduction devices in the ITA".⁴¹ Moreover, he added, in applying this principle, Estey J.'s decision in *Stuart* "rejected the suggestion that a distinction must be drawn between non-arm's length and arm's length transactions".⁴² As a result, he concluded, "non-arm's length arrangements can also be created for the sole purpose of taking advantage of tax reduction devices".⁴³

(b) Analysis of *McClurg*

Having made these general observations, the rest of Iacobucci J.'s decision is devoted almost entirely to a detailed analysis of Dickson C.J.C.'s majority judgment in *McClurg*. Given the judicial history of the case, in which the two lower courts relied on Dickson C.J.C.'s suggestion that s. 56(2) generally does not apply to dividends while the Federal Court of Appeal emphasized other statements qualifying this general rule, Iacobucci J. understandably considered his primary task to be the clarification of these apparently contradictory views. Reaffirming the general rule that s. 56(2) does not apply to dividends, and rejecting any qualification or exception to this rule, the court allowed the taxpayer's appeal.

(i) *The General Rule*

With respect to the general rule that s. 56(2) does not apply to dividends, Iacobucci J.'s decision restated the two arguments for this conclusion that Dickson C.J.C. had set out in *McClurg*. First, Iacobucci J. explained, since the purpose of s. 56(2) is "to capture and attribute to the reassessed taxpayer 'receipts which he or she otherwise would have obtained'",⁴⁴ the provision "does not apply to dividend income since, until a dividend is declared, the profits belong to the corporation as retained earnings".⁴⁵ As Dickson C.J.C. had stated in *McClurg*:

40. *Neuman*, *supra*, footnote 10, at p. 188. The reference to *Stuart* is to the Supreme Court of Canada decision in *Stuart Investments Ltd. v. The Queen*, *supra*, footnote 37.

41. *Neuman*, *ibid.*

42. *Ibid.*

43. *Ibid.*

44. *Ibid.*, at p. 190, citing *McClurg*, *supra*, footnote 6, at pp. 183-84.

45. *Neuman*, *ibid.*

The purpose of subsection 56(2) is to ensure that payments which otherwise would have been received by the taxpayer are not diverted to a third party as an anti-avoidance [*sic*] technique. This purpose is not frustrated because, in the corporate law context, until a dividend is declared, the profits belong to a corporation as a juridical person . . . Had a dividend not been declared and paid to a third party, it would not otherwise have been received by the taxpayer. Rather, the amount simply would have been retained as earnings by the company. Consequently, as a general rule, a dividend payment cannot reasonably be considered a benefit diverted from a taxpayer to a third party within the contemplation of subsection 56(2).⁴⁶

According to Iacobucci J., these comments, though not explicit, concern the fourth element necessary to the application of s. 56(2): that the payment or transfer of property would have been included in the taxpayer's income if it had been made to the taxpayer rather than the third party. In effect, he explained, "this Court implicitly interpreted the fourth precondition to include an *entitlement* requirement: entitlement is used in the sense that the reassessed taxpayer would have otherwise received the payments in dispute".⁴⁷ Thus, he concludes:

. . . unless a reassessed taxpayer had a preexisting entitlement to the dividend income paid to the shareholder of a corporation, the fourth precondition cannot be satisfied and consequently s. 56(2) cannot operate to attribute the dividend income to that taxpayer for income tax purposes.⁴⁸

Second, Iacobucci J. added, an interpretation of s. 56(2) that excludes dividend income "is the only interpretation which makes sense and which avoids absurdity in the application of s. 56(2)".⁴⁹ As Dickson C.J.C. emphasized in *McClurg*:

If this Court were to find otherwise, corporate directors potentially could be found liable for the tax consequences of any declaration of dividends made to a third party . . . [T]his would be an unrealistic interpretation of the subsection consistent with neither its object nor its spirit. It would violate fundamental principles of corporate law and the realities of commercial practice and would "overshoot" the legislative purpose of the section.⁵⁰

In order to avoid these consequences, therefore, s. 56(2) must be interpreted to exclude the payment of dividends.

46. *McClurg*, *supra*, footnote 6, at p. 184.

47. *Neuman*, *supra*, footnote 10, at p. 190.

48. *Ibid.*, at p. 191.

49. *Ibid.*, at p. 190.

50. *McClurg*, *supra*, footnote 6, at p. 184.

(ii) Qualifications

Notwithstanding these arguments for a general rule excluding dividend income from the scope of s. 56(2), Dickson C.J.C.'s judgment in *McClurg* also made a number of comments apparently qualifying this rule. First, he added: "Although I have concluded that s. 56(2) does not apply to the declaration of dividends generally, its application also would be contrary to the commercial reality of this particular transaction."⁵¹ Noting that the recipient of discretionary dividends in *McClurg* (the taxpayer's wife, Wilma McClurg) had made "very real contributions, financial and operational" to the company paying the dividends,⁵² Dickson C.J.C. emphasized that the dividend payment at issue in the case was "the product of a bona fide business relationship" representing "a legitimate *quid pro quo*" and "not simply an attempt to avoid the payment of taxes".⁵³ More importantly, he suggested:

In my opinion, if a distinction is to be drawn in the application of subsection 56(2) between arms length and non arms length transactions, it should be made between the exercise of a discretionary power to distribute dividends when the non arms length shareholder has made no contribution to the company (in which case subsection 56(1) [*sic*] may be applicable), and those cases in which a legitimate contribution has been made. In the case of the latter, of which this appeal is an example, I do not think it can be said that there was no legitimate purpose to the dividend distribution.⁵⁴

As the judicial history in *Neuman* suggests, these comments, following immediately after the declaration of a general rule excluding dividend payments from the scope of s. 56(2), created considerable uncertainty.⁵⁵ Were these comments part of the *ratio decidendi*, or merely *obiter dicta*? More importantly, even if *obiter*, what, if any, weight should they be given in a case such as *Neuman*, where a non-arm's length recipient of discretionary dividends had made no contribution to the company paying the dividends?

In the Federal Court of Appeal, Isaac C.J. emphasized that "the applicability of section 56(2) to non-arm's length transactions

51. *Ibid.*, at p. 185.

52. *Ibid.*

53. *Ibid.*

54. *Ibid.*

55. On the uncertainty resulting from the decision in *McClurg*, see Krishna and VanDuzer, *supra*, footnote 29, at p. 361, commenting that the court's emphasis on the "legitimate contribution" of the dividend recipient "muddles the issue for future cases and leaves the law in a state of uncertainty".

was a live one in *McClurg*, but concluded that Dickson C.J.C.'s comments on this point "could not be considered part of the *ratio decidendi*" in light of the court's finding that the dividend recipient had made a legitimate contribution to the company paying the dividends.⁵⁶ Nonetheless, he held: "Although not necessary for the disposition of that appeal, the opinion expressed by the Chief Justice represented the considered opinion of a majority of the Court and was therefore binding on the Courts below and on this Court."⁵⁷ Paying heed to Dickson C.J.C.'s opinion, therefore, and noting that Mrs. Neuman had "made no contribution to the company and assumed none of the risks for it", the Federal Court of Appeal held that s. 56(2) applied to attribute to the taxpayer the dividends that Mrs. Neuman received in 1982.

In the Supreme Court of Canada, Iacobucci J. reconsidered Dickson C.J.C.'s qualifying comments, rejecting any qualification or exception to the general rule expressed in *McClurg* that s. 56(2) does not apply to the payment of dividends. First, he explained, these comments were concerned primarily with the "third precondition" to the application of s. 56(2): "that the payment must be for the benefit of the reassessed taxpayer or for the benefit of another person whom the reassessed taxpayer wished to benefit".⁵⁸ According to Iacobucci J.:

In [Dickson C.J.C.'s] view, Wilma McClurg's receipt of the funds was not a "benefit" as required by s. 56(2) (the third precondition) since her contributions to the corporate enterprise could be described as a "legitimate *quid pro quo* and were not simply an attempt to avoid the payment of taxes" . . . Since Wilma McClurg had made legitimate contributions to the corporation, the application of s. 56(2) "would be contrary to the commercial reality of this particular transaction".⁵⁹

More significantly, Iacobucci J. continued, in his comments on the possible application of s. 56(2) to dividend payments to a non-arm's length shareholder who has made no contribution to the company Dickson C.J.C. appears to disregard the entitlement requirement previously read into the fourth precondition to the application of s. 56(2). According to Iacobucci J.:

Dickson C.J. is suggesting, it would seem, that where a non-arm's length shareholder receives a dividend from a corporation to which he or she has

56. *Neuman v. M.N.R.*, *supra*, footnote 14, at p. 294.

57. *Ibid.*

58. *Neuman*, *supra*, footnote 10, at p. 192.

59. *Ibid.*

made no contribution (the dividend income therefore constituting a "benefit" for the purposes of s. 56(2) in Dickson C.J.'s view), precondition four, interpreted by him to include an entitlement requirement, is automatically considered satisfied, or need not be satisfied, with the result that s. 56(2) applies.⁶⁰

In other words, Iacobucci J. concludes, by qualifying the general rule that s. 56(2) does not apply to dividends in the context of dividend payments to a non-arm's length shareholders making no contribution to the company paying the dividends, Dickson C.J.C. created an exception not only to the general rule but to the more basic requirement read into the fourth precondition that the reassessed taxpayer would otherwise have been entitled to the payment or transfer of property.

Having thus interpreted Dickson C.J.C.'s qualifying comments as "an exception to the general rule that s. 56(2) does not apply to dividend income",⁶¹ Iacobucci J. presented several reasons why such an exception is unwarranted. First, he argued, Dickson C.J.C.'s approach "ignores the fundamental nature of dividends" which are "related by way of entitlement to one's capital or share interest in the corporation and not to any other consideration".⁶² Assuming that "proper consideration was given for the shares when issued", he explained, there is no "principle of corporate law" that "requires in addition that a so-called 'legitimate contribution' be made by a shareholder to entitle him or her to dividend income".⁶³ As a result, since "it is well accepted that tax law embraces corporate law principles unless such principles are specifically set aside by a taxing statute", Iacobucci J. sees no justification for an exception to the rule that s. 56(2) does not apply to dividend income where a non-arm's length shareholder has not made a "legitimate contribution" to the company.⁶⁴

60. *Ibid.*, at p. 193.

61. *Ibid.*

62. *Ibid.*, at 192, adding that "the quantum of one's contribution to a company, and any dividends received from that corporation, are mutually independent of one another" and citing La Forest J.'s dissenting reasons in *McClurg*, *supra*, footnote 6, where he stated at p. 195 that:

To relate dividend receipts to the amount of effort expended by the recipient on behalf of the payor corporation is to misconstrue the nature of a dividend. As discussed earlier, a dividend is received by virtue of ownership of the capital stock of the 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.

63. *Neuman*, *ibid.*, at p. 193.

64. *Ibid.*

Second, Iacobucci J. continued, "there is no principled basis" upon which it is possible to draw Dickson C.J.C.'s proposed distinction between the payment of dividends generally and the payment of dividends to a non-arm's length shareholder who has made no contribution to the corporation. On the contrary, he argued:

[T]he fact that a company is closely held or that no contribution is made to the company by a shareholder benefiting from a dividend in no way changes the underlying nature of a dividend. Neither the fact that the transaction is non-arm's length nor the fact that the shareholder has not contributed to the corporation serves to overcome the conclusion that dividend income cannot satisfy the fourth precondition to attribution under s. 56(2).⁶⁵

Third, he adds, any rule based on a non-arm's length shareholder's "legitimate contribution" to the company paying the dividends creates a "difficult task of determining what constitutes a legitimate contribution".⁶⁶ Questioning "the criteria upon which one can ascertain with any degree of precision or certainty that a contribution is legitimate",⁶⁷ Iacobucci J. suggested, without stating so explicitly, that Dickson C.J.C.'s proposed qualification to the general rule excluding dividend income from the scope of s. 56(2) is unworkable.

Finally, Iacobucci J. concluded, to recognize an exception to the general rule that s. 56(2) does not apply to dividend income where a non-arm's length recipient has not made a legitimate contribution to the corporation would contradict fundamental principles of Canadian income tax law, according to which "taxpayers are entitled to arrange their affairs for the sole purpose of achieving a favourable position regarding taxation and no distinction is to be made in the application of this principle between arm's length and non-arm's length transactions".⁶⁸ According to Iacobucci J.:

Implicit in the distinction between non-arm's length and arm's length transactions is the assumption that non-arm's length transactions lend themselves to the creation of corporate structures which exist for the sole purpose of avoiding tax and therefore should be caught by s. 56(2) . . . The *ITA* has many specific anti-avoidance provisions and rules governing the treatment of non-arm's length transactions. We should not be quick to embellish the provision at issue here when it is open for the legislator to be precise and specific with respect to any mischief to be avoided.⁶⁹

65. *Ibid.*

66. *Ibid.*

67. *Ibid.*

68. *Ibid.*, at p. 194.

69. *Ibid.*

In the absence of any general distinction between arm's length and non-arm's length transactions or any specific reference to non-arm's length transactions in s. 56(2), therefore, such a distinction should not be read into the provision.

(iii) Conclusion

Reaffirming the general rule in *McClurg* that s. 56(2) does not apply to dividend income and rejecting any qualification or exception to this rule, the Supreme Court of Canada necessarily concluded that s. 56(2) could not apply to the dividends that Mrs. Neuman received from Melru. According to Iacobucci J.: "I conclude that s. 56(2) does not apply to dividend income such that the dividend income received by Ruby Neuman cannot be attributed to the appellant for income tax purposes."⁷⁰ The appeal was allowed, the decision of the Federal Court of Appeal was reversed, and that portion of the reassessment attributing to Mr Neuman the dividends received from Melru by Mrs. Neuman was set aside.

III. EVALUATION

While the Supreme Court of Canada decision in *Neuman* effectively restates Dickson C.J.C.'s argument in *McClurg* for a general rule excluding dividend payments from the scope of s. 56(2), it does little to explain Dickson C.J.C.'s qualifying comments, dismissing his statement on the possible application of s. 56(2) to dividend payments to a non-arm's length shareholder who has made no contribution to the company paying the dividends as an unwarranted and largely inexplicable exception to the general rule. This section of the article argues that as a result, the decision disregards the text of s. 56(2), misinterprets Dickson C.J.C.'s judgment in *McClurg*, contradicts prior cases in which s. 56(2) and its predecessor have been applied to payments or transfers of property by a corporation to a third party whom a director-shareholder desired to benefit notwithstanding that the director-shareholder was not immediately entitled to the payment or transfer of the property, and produces consequences at odds with the scheme of the Act and basic principles of tax fairness.

This section re-examines the Supreme Court of Canada decision in *Neuman* in light of the text of s. 56(2), the purpose of this

70. *Ibid.*, at p. 179.

provision, and the practical consequences of alternative interpretations.⁷¹ While this analysis supports a general rule, such as that affirmed in *McClurg*, according to which "the declaration of a dividend is normally beyond the scope of s. 56(2)",⁷² it does not support an absolute rule, such as that adopted in *Neuman*, according to which s. 56(2) cannot apply to any dividends except those to which a reassessed taxpayer had a preexisting entitlement.⁷³ On the contrary, it concludes that where the payment of a discretionary dividend benefits the reassessed taxpayer or some other person upon whom the taxpayer desired to confer a benefit, as it did in *Neuman*, the dividend should be subject to the attribution rule in s. 56(2).

1. Textual Analysis

Among the most significant considerations in statutory interpretation is the text of the relevant statute, both the provision at issue and the statute as a whole. Although the words of an Act are, as the Supreme Court of Canada has emphasized on several occasions, properly read "in their entire context and their grammatical and ordinary sense, harmoniously with the scheme of the Act, the object of the Act, and the intention of Parliament",⁷⁴ attention to the words of the statutory text is a basic tenet of statutory interpretation, constraining judicial discretion and reflecting widely held values associated with legislative supremacy and the rule of law.⁷⁵ In the interpretation of the Income Tax Act, both the "plain meaning rule" and the "words-in-total-context approach" place primary emphasis on the words of the statutory text, though they differ in the manner

71. Consideration of these various factors is consistent with the explicitly pragmatic approach to statutory interpretation that I advocate elsewhere. See David G. Duff, "Interpreting the *Income Tax Act* - Part II: Towards a Pragmatic Approach" (1999), 47 *Can. Tax J.* (forthcoming). To the extent that the Supreme Court of Canada considers textual, purposive, and consequential considerations to interpret provisions of the *Income Tax Act*, I argue among other things that the court's actual practice of statutory interpretation is implicitly pragmatic notwithstanding the specific interpretive doctrine (e.g., teleological approach or plain meaning rule) to which the court actually refers.

72. *McClurg*, *supra*, footnote 6, at p. 185 (emphasis added).

73. *Neuman*, *supra*, footnote 10, at p. 191.

74. See, e.g., *Stuart*, *supra*, footnote 37, at p. 316, citing E.A. Driedger, *Construction of Statutes*, 2nd ed. (Toronto, Butterworths, 1983), p. 87.

75. See, e.g., William Eskridge, Jr. and Philip Frickey, "Statutory Interpretation as Practical Reasoning" (1990), 42 *Stan. L. Rev.* 321 at p. 354, explaining that: "All that is enacted into law is the statutory text, and at the very least legislative supremacy means that an interpreter must be attentive to the text. Functionally, citizens and lawmakers will rely on the apparent meaning of statutory texts. Textual primacy can also be a useful concrete limit on judicial power."

in which these words are construed.⁷⁶ In interpreting s. 56(2), therefore, a reasonable starting point is the words of the provision itself.

As the Supreme Court of Canada affirms in *Neuman*, the text of s. 56(2) specifies four elements or "preconditions" to the application of the rule:

- (1) the payment must be to a person other than the reassessed taxpayer;
- (2) the allocation must be at the direction of or with the concurrence of the reassessed taxpayer;
- (3) the payment must be for the benefit of the reassessed taxpayer or for the benefit of another person whom the reassessed taxpayer wished to benefit; and
- (4) the payment would have been included in the reassessed taxpayer's income if it had been received by him or her.⁷⁷

In the Federal Court of Appeal, Isaac C.J. concluded that the dividend payment to Mrs. Neuman satisfied each of these elements: a payment of property was made to Mrs. Neuman; the payment was made with the concurrence of Mr Neuman; the payment was for the benefit of Mr Neuman; and the payment would have been included in Mr Neuman's income if it had been made to him rather than Mrs. Neuman.⁷⁸ Although it might have been more persuasive to characterize the payment not as a benefit to Mr Neuman but as a benefit that Mr Neuman desired to confer on Mrs. Neuman,⁷⁹ this textual analysis suggests that the dividend income should have been caught by s. 56(2).

On appeal, however, the Supreme Court of Canada relied on Dickson C.J.C.'s decision in *McClurg* to hold that "dividend income, by its very nature, cannot satisfy the fourth precondition".⁸⁰ According to Iacobucci J.: "Dividend income cannot pass the fourth test because the dividend, if paid to a shareholder, remains with the corporation as retained earnings; the reassessed taxpayer, as either director or shareholder of the corporation, has no entitlement to the

76. These doctrinal approaches, and leading tax cases in which they have been applied, are reviewed in David G. Duff, "Interpreting the *Income Tax Act* - Part I: Interpretive Doctrines" (1999), 47 *Can. Tax J.* 464.

77. *Supra*, footnote 10, at p. 186, citing *Murphy v. The Queen*, [1980] C.T.C. 386, 80 D.T.C. 6314 at pp. 6317-318 (F.C.T.D.); and *Fraser Companies v. The Queen*, [1981] C.T.C. 61, 81 D.T.C. 5051 at p. 5058 (F.C.T.D.).

78. See *supra*, footnotes 14-18 and accompanying text.

79. See *supra*, footnote 17.

80. *Neuman*, *supra*, footnote 10, at p. 186.

money."⁸¹ On this basis, the court concluded, the dividend payment to Mrs. Neuman was not subject to the attribution rule in s. 56(2).

Based on a textual analysis, however, an obvious problem with the court's interpretation is its apparent inconsistency with the words of the statutory provision. While the text of s. 56(2) requires a payment or transfer of property satisfying the first three preconditions to be "included in computing the taxpayer's income to the extent that it would be if the payment or transfer *had been made* to the taxpayer", the court reads the fourth precondition in s. 56(2) as if it applied only if "the reassessed taxpayer would have otherwise *received* the payments in dispute".⁸² Absent a compelling argument that this interpretation is mandated by the scheme of the Act, the object of the Act, the intention of Parliament, or the consequences of a more straightforward reading of the text, such a marked departure from the words of the text raises significant concerns about judicial discretion and fidelity to principles of legislative supremacy.

In *Neuman*, of course, Iacobucci J. relied on Dickson C.J.C.'s analysis in *McClurg* to conclude that a general rule excluding dividend income from the scope of s. 56(2) was not only "consistent with the stated purpose of s. 56(2) . . . to capture and attribute to the reassessed taxpayer 'receipts which he or she would otherwise have obtained'",⁸³ but also "the only interpretation which makes sense and which avoids absurdity in the application of s. 56(2)".⁸⁴ The extent to which it is necessary to depart from the words of the statutory text, therefore, depends on the strength of the court's purposive and consequential analysis.

2. Purposive Analysis

In addition to the words of the relevant statute and provision, courts frequently consider the object or purpose of the text in order to assist in its interpretation. By reading statutory provisions not literally but in light of "the scheme of the Act, the object of the Act, and the intention of Parliament",⁸⁵ courts co-operate in the fulfilment of legislative aims and intentions in a manner consistent

81. *Ibid.*, at p. 190.

82. *Ibid.* (emphasis added).

83. *Ibid.*, citing *McClurg*, *supra*, footnote 6, at p. 184.

84. *Ibid.*

85. Driedger, *supra*, footnote 74, at p. 87.

with the democratic values associated with the principle of legislative supremacy.⁸⁶ In at least one recent tax case, moreover, the Supreme Court of Canada suggested that in the interpretation of any statute, including tax statutes, courts should "first . . . determine the purpose of the legislation, whether as a whole or as expressed in a particular provision"⁸⁷ and apply a strict or liberal approach to the provision at issue "depending on the purpose underlying it".⁸⁸

Consistent with this purposive or teleological approach, Dickson C.J.C.'s analysis of s. 56(2) in *McClurg* began by considering not the text of the provision but its purpose. At the outset, therefore, he referred to a prior decision in which the Exchequer Court stated that:

. . . s. 16(1) [the predecessor to current s. 56(2)] is intended to cover cases where a taxpayer seeks to avoid receipt of what in his hands would be income by arranging to have the amount received by some other person whom he wishes to benefit or by some other person for his own benefit. The scope of the subsection is not obscure for one does not speak of benefitting a person in the sense of the subsection by making a business contract with him for adequate consideration.⁸⁹

Similarly, Dickson C.J.C. concluded, s. 56(2) "is designed to prevent avoidance by the taxpayer, through the direction to a third party, of receipts which he or she otherwise would have obtained".⁹⁰ In addition, he explained, "the subsection reasonably cannot have been intended to cover benefits conferred for adequate consideration in the context of a legitimate business relationship".⁹¹ While the first of these propositions involves the fourth precondition to the application of s. 56(2) that the payment or transfer of property

86. See, e.g., J.A. Corry, "Administrative Law and the Interpretation of Statutes" (1936), 1 U.T.L.J. 286 at p. 289, emphasizing the importance of "intelligent judicial co-operation" in a parliamentary democracy in "the fulfilment of the aims and objects of parliament". See also Eskridge and Frickey, *supra*, footnote 75, at p. 356, observing that: "Original legislative expectations are important in a democracy where the legislature is the primary source of lawmaking . . . To the extent that the Court can recover that original meaning, it subserves democratic values by enforcing the law as the legislature understood it, thus limiting judicial discretion and power."

87. *Corporation Notre-Dame de Bon-Secours v. Québec*, [1995] 1 C.T.C. 241 at p. 250, 95 D.T.C. 5017 (S.C.C.).

88. *Ibid.*, at p. 252. For a more detailed explanation of this purposive or teleological approach, reviewing leading tax cases in which it has been defined and applied, see Duff, "Interpreting the *Income Tax Act* - Part I: Interpretive Doctrines", *supra*, footnote 76, at pp. 485-504.

89. *Miller v. M.N.R.*, *supra*, footnote 6, at p. 212.

90. *McClurg*, *supra*, footnote 6, at pp. 183-84.

91. *Ibid.*, at p. 184.

would have been included in the reassessed taxpayer's income if it had been made to him or her, the second proposition concerns the third precondition that the payment or transfer of property must benefit the reassessed taxpayer or some other person upon whom the reassessed taxpayer desired to confer a benefit.

In light of this purposive analysis, Dickson C.J.C. adopted a strict approach to the interpretation of s. 56(2), concluding as an initial matter that the provision does not apply to dividend income since dividends, if not declared and paid, "would not otherwise have been received by the taxpayer" but "would simply have been retained as earnings by the company" to which corporate profits otherwise "belong . . . as a juridical person".⁹² On the other hand, he suggested, s. 56(2) might apply to "the exercise of a discretionary power to distribute dividends" where dividends are paid to a "non-arm's length shareholder [who] has made no contribution to the company" paying the dividends.⁹³ As a result, he concluded, "the declaration of a dividend is normally beyond the scope of s. 56(2) of the *Income Tax Act*".⁹⁴

In *Neuman*, however, Iacobucci J. rejected any qualification to the general rule excluding dividend income from the scope of s. 56(2), reaffirming Dickson C.J.C.'s initial conclusion that because the purpose of s. 56(2) is "to capture and attribute to the reassessed taxpayer 'receipts which he or she otherwise would have obtained'",⁹⁵ the provision "does not apply to dividend income since, until a dividend is declared, the profits belong to the corporation as retained earnings".⁹⁶

(a) Entitlement Requirement

Accepting the court's characterization of the purpose of s. 56(2) to attribute to the reassessed taxpayer payments or transfers of property that he or she "otherwise would have obtained",⁹⁷ there are at least two problems with the conclusion in *Neuman* that this

92. *Ibid.*

93. *Ibid.*, at p. 185.

94. *Ibid.* (emphasis added).

95. *Neuman*, *supra*, footnote 10, at p. 190, citing *McClurg*, *supra*, footnote 6, at pp. 183-84.

96. *Ibid.*

97. *McClurg*, *supra*, footnote 6, at pp. 183-84 (C.T.C.). Although the legislative record contains no commentary on the purpose of then s. 16(1) when it was introduced in 1948, this purpose is widely accepted by courts and commentators and broadly consistent with the words of the statutory text. See the cases and commentaries cited *supra*, footnote 6.

purpose excludes all dividend income from the scope of the provision. First, while the court's purposive analysis justifies the inclusion of an entitlement requirement to the fourth precondition that the payment or transfer of property would have been included in the reassessed taxpayer's income if it had been made to him or her, it does not necessitate that this entitlement be direct or immediate as opposed to indirect or prospective. Indeed, although it is true that a dividend payment, if not made to one class of shareholders, remains the property of the corporation as a separate juridical person, it is also true that the non-payment of dividends on one class of shares increases either the cash available for the payment of dividends on other share classes or the value of these other shares if retained by the company. In either event, as I have argued elsewhere:

. . . to the extent that other shareholders have a prospective though not immediate right to the profits from which a dividend is paid, it is arguable that but for the payment of a dividend on one class of shares, shareholders of other classes would have obtained these profits in one form or another.⁹⁸

For this reason, it follows that the application of s. 56(2) to dividend payments is entirely consistent with its accepted purpose "to prevent avoidance by the taxpayer, through the direction to a third party, of receipts which he or she otherwise would have obtained".⁹⁹ Indeed, to hold otherwise is, to use Dickson C.J.C.'s expressions, both "formalistic in the extreme" and "contrary to commercial reality".¹⁰⁰

Second, while a rule excluding all dividend income from the scope of s. 56(2) depends on an immediate entitlement requirement in the sense that the reassessed taxpayer would have otherwise received the payments in dispute directly, this requirement was explicitly rejected in at least two decisions in which the provision was held to apply to shareholders of closely held companies who directed or concurred in the payment or transfer of property to third parties, notwithstanding that these shareholders were not immediately entitled to the property themselves. In *M.N.R. v. Bronfman*,¹⁰¹ for example, then s. 16(1) was applied to attribute to a director-shareholder of a closely held corporation a *pro rata* share

98. Duff, "Interpreting the *Income Tax Act* - Part I: Interpretive Doctrines", *supra*, footnote 76, at p. 499.

99. *McClurg*, *supra*, footnote 6, at pp. 183-84.

100. *Ibid.*, at pp. 184 and 185 (C.T.C.).

101. *Supra*, footnote 6.

of the value of certain gifts made by the corporation to various family members, former employees, and their dependents. Rejecting the taxpayer's argument that the application of then s. 16(1) required "personal ownership of the moneys . . . paid out" in the form of gifts, Dumoulin J. replied:

I would think not, because . . . the section's clear enough purpose is the taxation of indirect payments under circumstances such as the instant ones. If so, then, a norm or basis of assessment must be set, and this was done by Parliament assimilating the payer's funds, corporate body or third party of any other description, to the personal income of the taxpayer directing these payments or merely concurring in their performance, to the extent that they would have increased his income had they been made to him.¹⁰²

By attributing to the taxpayer a *pro rata* share of the value of the gifts based on his percentage shareholding in the company, however, the court assumed a requirement of indirect or prospective entitlement.

Similarly, in *Outerbridge Estate v. Canada*,¹⁰³ the Federal Court of Appeal applied s. 56(2) to attribute to the controlling shareholder of an investment holding company a *pro rata* share of the difference between the fair market value of shares sold by the company to the taxpayer's son-in-law (\$1,089 per share) and the amount paid by the purchaser (\$100 per share). Rejecting the view that s. 56(2) requires the taxpayer to have been immediately entitled to the property which is paid or transferred to the third party, Marceau J.A. (MacGuigan and Décary J.J.A., concurring) concluded that:

The fact that [the taxpayer] had no direct right to the shares would have a bearing if the provision was to be construed as covering only cases of diversion of income receivable by the taxpayer and there is no indication whatever that the provision was meant to be so confined.

.....

[T]he language of the provision does not require, for its application, that the taxpayer be initially entitled to the payment or transfer of property made to the third party, only that he would have been subject to tax had the payment or transfer been made to him.¹⁰⁴

Although the attribution of an amount based on the taxpayer's percentage shareholding in the investment holding company reflects a notion of prospective entitlement, consistent with the stated

purpose of s. 56(2) to attribute amounts diverted to third parties which the taxpayer "would otherwise have obtained",¹⁰⁵ the court did not insist on an immediate entitlement requirement.

While Dickson C.J.C. considered neither of these decisions in *McClurg*, Iacobucci J. acknowledged in *Neuman* that "the decision in *Outerbridge Estate* . . . appears to challenge the view that where a taxpayer is not entitled to a payment that the payment cannot be attributed to him or her under s. 56(2)".¹⁰⁶ Nonetheless, he concluded, because "*Outerbridge Estate* concerned the conferral of a benefit which was not in the form of dividend income",¹⁰⁷ it does not affect the general rule in *McClurg* that s. 56(2) does not apply to dividend income. Since the formulation of a general rule excluding dividends from the scope of s. 56(2) depends on the inclusion of an immediate entitlement requirement in the fourth precondition, however, this assumed distinction cannot be sustained. Indeed, since s. 56(2) refers to a "payment or transfer of property", it is unclear on what principled basis any distinction between dividend income and other payments or transfers of property might rest.

(b) Benefit Requirement

Although the court's purposive analysis in *McClurg* and *Neuman* does not support an absolute rule excluding all dividend income from the scope of s. 56(2), Dickson C.J.C.'s analysis of the third precondition in *McClurg* provides a more convincing reason for a "general rule" according to which dividends are "normally beyond the scope" of this provision.¹⁰⁸ Since s. 56(2) "reasonably cannot have been intended to cover benefits conferred for adequate consideration in the context of a legitimate business relationship",¹⁰⁹ it follows that the provision should not apply to the declaration and payment of dividends in the context of ordinary commercial relationships between arm's length parties. Nor should it apply to dividends paid to a non-arm's length shareholder who has provided adequate consideration for the shares in the context of a legitimate business relationship. Consequently, as Dickson C.J.C.

105. *McClurg*, *supra*, footnote 6, at pp. 183-84.

106. *Neuman*, *supra*, footnote 10, at p. 190. Iacobucci J.'s decision does not, however, consider the decision in *Bronfman*.

107. *Ibid.*, at p. 191.

108. *McClurg*, *supra*, footnote 6, at pp. 184 and 185.

109. *Ibid.*, at p. 184.

102. *Ibid.*, at p. 384.

103. *Supra*, footnote 6.

104. *Ibid.*, at pp. 116-17.

concludes, "as a general rule, a dividend payment cannot reasonably be considered a *benefit* diverted from a taxpayer to a third party within the contemplation of s. 56(2)".¹¹⁰

In contrast, where discretionary dividends are paid as part of an income-splitting arrangement to a non-arm's length shareholder in an amount greatly exceeding the consideration for the shares when issued and any other contribution which might justify the payment of such a dividend as a legitimate *quid pro quo*, it is reasonable to regard the payment as a benefit which the shareholder or shareholders directing or concurring in the payment desired to confer upon the recipient. In these circumstances, it follows, application of s. 56(2) is consistent not only with the text of the provision but with its accepted purposes both "to capture and attribute to the reassessed taxpayer 'receipts which he or she otherwise would have obtained'"¹¹¹ and "to prevent tax avoidance through income splitting".¹¹²

For this reason, moreover, Dickson C.J.C.'s suggestion in *McClurg* that s. 56(2) might apply to the payment of a discretionary dividend to a non-arm's length shareholder who has made no contribution to the company paying the dividend is best understood not as an exception to the entitlement requirement included in the fourth precondition (since this entitlement may be prospective or indirect), but as an expression of the third precondition that the payment or transfer of property benefit the reassessed taxpayer or some other person upon whom the reassessed taxpayer desired to confer a benefit. Although a purposive analysis of this third precondition supports a "general rule" according to which dividend payments are "normally beyond the scope of s. 56(2)",¹¹³ this rule does not extend to circumstances in which the payment of a dividend may reasonably be regarded as a benefit within the meaning of this provision.

On this account, finally, Iacobucci J.'s objections in *Neuman* to Dickson C.J.C.'s *obiter dicta* as an unwarranted exception to the general rule excluding dividend income from the scope of s. 56(2) are ultimately misplaced. Without a direct or immediate entitlement requirement to the fourth precondition, the payment of a

110. *Ibid.* (emphasis added).

111. *Neuman, supra*, footnote 10, at p. 190, citing *McClurg, supra*, footnote 6, at pp. 183-84.

112. *Neuman, ibid.*, at p. 187.

113. *McClurg, supra*, footnote 6, at pp. 184 and 185.

dividend may be subject to attribution under s. 56(2) where it benefits the reassessed taxpayer or another person upon whom the reassessed taxpayer desired to confer a benefit. To suggest that this provision may apply to the payment of a discretionary dividend to a non-arm's length shareholder who has made no contribution to the company paying the dividend, therefore, neither "ignores the fundamental nature of dividends" nor draws an inappropriate distinction between arm's length and non-arm's length transactions.¹¹⁴ On the contrary, it merely illustrates an obvious factual circumstance, exemplified by the transactions in *Neuman*, in which the payment of a dividend might reasonably be regarded as a benefit within the meaning of s. 56(2).

3. Consequential Analysis

In addition to textual and purposive analysis, courts often consider the practical consequences of different interpretations, regarding those considered fair and reasonable more favourably than those considered unjust or unreasonable.¹¹⁵ The traditional "golden rule", for example, has long allowed courts to depart from the plain words of a statute in order to avoid "absurd" or "anomalous" results.¹¹⁶ In the interpretation of the Income Tax Act, the Supreme Court of Canada has often employed consequential analysis to support one interpretation over another.¹¹⁷ Likewise in *McClurg* and *Neuman*, the Supreme Court of Canada considered the consequences of alternative interpretations to justify a rule excluding dividends from the scope of s. 56(2).

In *McClurg*, for example, Dickson C.J. reasoned that if s. 56(2) were to apply to dividend income, "corporate directors potentially

114. *Neuman, supra*, footnote 10, at pp. 192-94.

115. On the role of consequential analysis in statutory interpretation see Ruth Sullivan, *Driedger on the Construction of Statutes*, 3rd ed. (Toronto, Butterworths, 1994) at pp. 79-99.

116. See, e.g., *Grey v. Pearson* (1857), 10 E.R. 1216 (H.L.), per Lord Wensleydale, stating (at p. 12) that "the grammatical and ordinary sense of words is to be adhered to, unless that would lead to some absurdity, or some repugnance or inconsistency with the rest of the instrument, in which case the grammatical and ordinary sense of the words may be modified, so as to avoid that absurdity and inconsistency, but no farther". See also the discussion of this rule in the context of Canadian income tax cases in Duff, "Interpreting the *Income Tax Act* - Part I: Interpretive Doctrines," *supra*, footnote 76, at pp. 480-82.

117. See the section on "Consequential Analysis" in Duff, "Interpreting the *Income Tax Act* - Part II: Towards a Pragmatic Approach", *supra*, footnote 71.

could be found liable for the tax consequences of any declaration of dividends to a third party", explaining that this result "would violate fundamental principles of corporate law and the realities of commercial practice and would 'overshoot' the legislative purpose of the section".¹¹⁸ For these same reasons, Iacobucci J. concluded in *Neuman* that the exclusion of dividend income from the scope of s. 56(2) "is the only interpretation which makes sense and which avoids absurdity in the application of s. 56(2)".¹¹⁹ In addition, Iacobucci J. suggested, if s. 56(2) were to apply to discretionary dividends paid to non-arm's length shareholders who do not make a "legitimate contribution" to the company paying the dividends, courts might face a "difficult task of determining what constitutes a legitimate contribution".¹²⁰ Finally, as others have argued, the application of s. 56(2) to dividend income could produce double taxation, with the same dividends taxed both in the hands of the reassessed taxpayer and the other person to whom they are paid.¹²¹

While the first of these consequential arguments would, if established, constitute a powerful objection to the application of s. 56(2) to dividend income, the purposive analysis of the previous section suggests that it exaggerates the potential scope of s. 56(2) by ignoring the third element necessary to its application: that the payment or transfer of property at issue be for the taxpayer's own benefit or the benefit of some other person upon whom the taxpayer desired to confer a benefit. As explained earlier, since s. 56(2) "reasonably cannot have been intended to cover benefits conferred for adequate consideration in the context of a legitimate business relationship",¹²² it should not apply to dividend payments made in the context of ordinary commercial relationships between arm's length parties. As a result, if dividend income were subject to s. 56(2), it does not follow that "corporate directors potentially could be found liable for the tax consequences of any declaration of dividends to a third party".¹²³ Consequently, the exclusion of dividend income from the scope of s. 56(2) is not "the only interpretation

which makes sense and which avoids absurdity in the application of s. 56(2)".¹²⁴

On the contrary, by excluding virtually all dividend income from the scope of s. 56(2), the decision in *Neuman* produces consequences at odds both with the scheme of the Act and basic principles of tax fairness. Although it is true, as Iacobucci J. observes in *Neuman*, that the ITA contains "no general scheme to prevent income splitting",¹²⁵ it is also true that the ITA contains several specific rules designed to prevent income splitting,¹²⁶ reflecting "an underlying philosophy that a taxpayer should not be able to divert income to another taxpayer for the purposes of reducing his or her marginal rate of tax."¹²⁷ To the extent that *Neuman* sanctions the payment of discretionary dividends for the sole purpose of income splitting, therefore, it contradicts this "underlying philosophy". To the extent that this kind of income splitting is most likely to be conducted by a rather select category of well-advised taxpayers with private corporations, moreover, *Neuman* undermines basic principles of tax fairness by allowing these taxpayers to minimize their tax burdens in a manner that is largely unavailable to the vast majority of taxpayers.

As for Iacobucci J.'s second consequential argument that courts could face a "difficult task determining the existence of a legitimate contribution", this concern is also exaggerated. Since the existence of a legitimate contribution is relevant only where discretionary dividends are paid in an amount greatly exceeding the issue price of the shares on which the dividends are paid, the need to consider this issue is likely to be confined to a relatively small number of cases, such as *McClurg*, where transactions which might otherwise be considered to have been designed to split income are characterized as "the product of a *bona fide* business relationship".¹²⁸ In addition, the determination of a "legitimate contribution" is no more difficult than the assessment of other standards such as fair market consideration which appear in other ITA provisions designed to prevent income splitting.¹²⁹ In any event, to the

124. *Neuman*, *supra*, footnote 10, at p. 190.

125. *Ibid.*, at p. 187 (C.T.C.), citing Krishna and VanDuzer, *supra*, footnote 29, at p. 367.

126. In addition to s. 56(2), see ITA ss. 56(4) to (4.3), s. 67, s. 69(1), and ss. 74.1 to 75.1.

127. Krishna and VanDuzer, *supra*, footnote 29, at p. 367. While the ITA contains specific exceptions to the attribution rules, these exceptions are generally limited (*e.g.*, to pension income) and specifically defined (*e.g.*, transfers or loans to small business corporations which are exempt from the attribution rule in s. 74.4).

128. *McClurg*, *supra*, footnote 6, at p. 185.

129. See s. 74.5 (1) of the ITA, which excludes transfers for fair market consideration from the attribution rules in s. 74.1(1) and (2) and s. 74.2. See also s. 69(1)(a), which deems taxpayers who acquire anything from non-arm's length persons at an amount in excess

118. *McClurg*, *supra*, footnote 6, at p. 184.

119. *Neuman*, *supra*, footnote 10, at p. 190.

120. *Ibid.*, at p. 193.

121. See, *e.g.*, Cherniawsky and Toy, *supra*, footnote 7, at p. 25.

122. *McClurg*, *supra*, footnote 6, at p. 184.

123. *Ibid.*

extent that s. 56(2) requires the existence of a "benefit" to the reassessed taxpayer or other person to whom the property at issue is paid or transferred, the need to determine whether this payment or transfer is "the product of a business contract made for adequate consideration"¹³⁰ is mandated both by the words of the Act and the purpose of the provision. For the court to resist this task because it is "difficult" is to ignore its responsibility to apply the provisions of the Act.

With respect to the third consequential argument that the application of s. 56(2) could result in double taxation, two responses are in order.¹³¹ First, to the extent that the dividend payment is calculated to produce no tax liability to the recipient, as appears to have been the case in *Neuman* where the dividend income was sheltered by the dividend tax credit and Mrs. Neuman's personal exemption, there is no double taxation. Indeed, to the extent that discretionary dividends are designed to split income with low-income spouses or children, the actual recipient is likely to pay little or no tax on the dividend income. Second, since other attribution rules specifically deem amounts to have been received by the transferor of property and not the actual recipient,¹³² the absence of such language in s. 56(2) and other rules designed to prevent income

of its fair market value to have acquired it at that fair market value; s. 69(1)(b), which deems taxpayers who dispose of anything to non-arm's length persons for no proceeds or for proceeds less than its fair market value to have received proceeds equal to that fair market value; and s. 67, which limits the amount that may be deducted in respect of an outlay or expense to the extent that the outlay or expense was "reasonable in the circumstances".

130. *McClurg*, *supra*, footnote 6, at p. 185.

131. The issue of double taxation in the application of s. 56(2) was considered in *Outerbridge Estate*, *supra*, footnote 6, and *Ascot Enterprises v. The Queen*, [1996] 1 C.T.C. 384, 96 D.T.C. 6015 (F.C.A.), neither of which involved the payment of dividends. In *Outerbridge Estate*, at pp. 117-18, the court adopted a "fifth precondition" to the application of s. 56(2), which was subsequently rejected by the Federal Court of Appeal in *Neuman*, according to which: "the validity of an assessment under s. 56(2) of the Act when the taxpayer had himself no entitlement to the payment made or the property transferred is subject to an implied condition, namely that the payee or transferee not be subject to tax on the benefit he received". In *Ascot Enterprises*, the court rejected the argument that s. 56(2) permits double taxation, responding at p. 389 that: "Double taxation exists where a single payment is taxed twice in the hands of the same taxpayer" (emphasis added). Nonetheless, acknowledging that "the application of s. 56(2) may lead to harsh consequences", it concluded that courts should interpret the provision in such a way that they not "infer too hastily" that a taxpayer has desired to confer a benefit on another person in cases "where the motive is not obvious". While the latter approach is consistent with the text of s. 56(2), the words of this provision provide no support for the addition of a fifth precondition.

132. See ITA ss. 74.1(1) and (2), 74.2(1), and 75.1(1).

splitting suggests that this result may not be unintended.¹³³ Although a general presumption against double taxation is consistent with the emphasis that this section places on the role of consequential analysis in statutory interpretation, an application of this or any other consequentialist presumption should be supported by the text of the statute or clear evidence of legislative intent. Otherwise, as Iacobucci J. himself emphasized in another leading tax case, "a normative assessment of the consequences of the application of a given provision is within the ambit of the legislature, not the courts".¹³⁴

4. Conclusion

While a purposive analysis of s. 56(2) supports a general rule, such as that in *McClurg*, according to which dividend payments are "normally beyond the scope of s. 56(2)",¹³⁵ neither the text of the provision nor its purpose nor consequential considerations support an absolute rule, such as that adopted in *Neuman*, according to which s. 56(2) cannot apply to any dividends except those to which a reassessed taxpayer had a preexisting entitlement.¹³⁶ As a result, it follows that the basis of the *Neuman* decision, that s. 56(2) could not apply to the dividends paid to Mrs. Neuman, cannot be sustained. On the contrary, to the extent that this payment satisfied each of the four preconditions to the application of s. 56(2), a share of the dividend payment based on his percentage shareholding in Melru should have been attributed to Mr Neuman.¹³⁷

IV. IMPLICATIONS

Although this comment argues that *Neuman* was wrongly decided, the decision stands as an authoritative statement of the law by the Supreme Court of Canada. This part considers the implications of the decision and subsequent legislative amendments for income splitting, tax avoidance, and statutory interpretation.

133. In addition to s. 56(2), see also ss. 67, s. 69(1) and 74.4, each of which permit the taxation of the same amount in the hands of two taxpayers.

134. *Antosko v. The Queen*, *supra*, footnote 37, at p. 33.

135. *McClurg*, *supra*, footnote 6, at p. 185.

136. *Neuman*, *supra* footnote 10, at p. 191.

137. Note that this result would have differed from the Minister's reassessment, which attributed the entire amount of the dividend to Mr Neuman. In so doing, the Minister appears to have ignored the prospective or indirect entitlement requirement that is properly included in the fourth precondition.

1. Income Splitting

As indicated earlier, the ITA contains several specific rules designed to prevent income splitting,¹³⁸ reflecting "an underlying philosophy that a taxpayer should not be able to divert income to another taxpayer for the purposes of reducing his or her marginal rate of tax".¹³⁹ While the ITA contains specific exceptions to the attribution rules, these exceptions are limited to specific kinds of transfers, such as the assignment of Canada or Quebec Pension Plan benefits to a spouse,¹⁴⁰ contributions to spousal RRSPs,¹⁴¹ or transfers or loans to small business corporations.¹⁴² On the other hand, the attribution rules are notoriously easy to avoid, applying for example to income from property transferred or lent to a spouse or minor child¹⁴³ but not income from a business the capital of which is provided by a spouse or parent,¹⁴⁴ and to capital gains on property lent or transferred to a spouse¹⁴⁵ but not capital gains on property lent or transferred to a minor child.¹⁴⁶ To the extent that *Neuman* sanctions the use of discretionary dividends to split income, therefore, the decision simply adds another technique to the numerous methods already employed to circumvent the ITA's various attribution rules.¹⁴⁷

138. In addition to s. 56(2), see ITA s. 56(4) to (4.3), ss. 67, s. 69(1), and 74.1 to 75.1.

139. Krishna and VanDuzer, *supra*, footnote 29, at p. 367.

140. This exception appears in ITA ss. 56(2) and (4) and 74.1(1).

141. See ITA s. 146(5.1) and (8.3), which permit a taxpayer to deduct contributions to a spouse's RRSP provided that these amounts are not withdrawn for at least two years.

142. See ITA s. 74.4, which exempts these transfers or loans from the corporate attribution rule otherwise set out in the provision.

143. ITA, s. 74.1(1) and (2).

144. See *Robins v. M.N.R.*, [1963] C.T.C. 27 at p. 30, 63 D.T.C. 1012 (Exch. Ct.), concluding that "... what is deemed to be the income of the transferor, and it is clearly stated, is income from property only. Indeed there is no mention of income from a business such as we have here and, therefore, this section can be of no assistance in determining whether the business profit resulting from the real estate transactions is taxable as income of the appellant or of his wife." For a critical commentary on this decision, see Gwyneth McGregor, "Interpretation of Taxing Statutes: Whither Canada?" (1968), 16 Can. Tax J. 122 at p. 132, commenting that "The intention of Parliament in enacting this provision is crystal clear; but that did not prevent the Exchequer Court ... from ... interpreting the section literally and strictly ... with the result of frustrating that intention."

145. ITA, s. 74.2(1).

146. An exception to this rule exists where farm property is transferred to a minor child on a tax-deferred basis under s. 73(3) or (4). See ITA s. 75.1.

147. For a detailed discussion of income-splitting techniques, see Cherniawsky and Toy, *supra*, footnote 7.

Although Revenue Canada may have lost in *Neuman*, however, other statutory provisions may permit different kinds of challenges to corporate share capital structures designed to split income. Under s. 74.4, for example, a taxpayer who loans or transfers property to a corporation for the purpose of reducing his or her income and benefiting a spouse or minor child may be deemed to receive interest computed at a prescribed rate on the outstanding amount of the loan or transferred property.¹⁴⁸ Although this provision did not apply to the years at issue in *Neuman*, it could apply to similar arrangements where a taxpayer loans or transfers property to a corporation for the purpose of splitting income.

Alternatively, where shares of a closely held company are issued for less than their fair market value to a spouse or minor child of a controlling shareholder, s. 74.1(1) or (2) may apply to attribute dividends on these shares back to the controlling shareholder on the grounds that he or she transferred property indirectly to the spouse or minor child.¹⁴⁹ Likewise, in these circumstances, s. 69(1) may apply to deem the controlling shareholder to have disposed of an economic interest in the company for proceeds equal to its fair market value.¹⁵⁰ While it is difficult to determine the fair market value of shares entitled to discretionary dividends, the payment of dividends in an amount greatly exceeding their issue price not long after their issuance may suggest that the shares were issued for consideration less than their fair market value.

As a final possibility, Revenue Canada might invoke the general anti-avoidance rule (GAAR) in s. 245 on the grounds that the issuance of shares to a spouse or minor child and/or the payment of discretionary dividends constitutes an avoidance transaction within the meaning of s. 245(3),¹⁵¹ resulting in a misuse of ITA provisions

148. This provision is explained more fully *supra*, footnote 32.

149. See, e.g., *Kieboom v. M.N.R.*, [1992] 2 C.T.C. 59, 92 D.T.C. 6382 (F.C.A.) and *Romkey v. The Queen*, [1997] 3 C.T.C. 2405 (T.C.C.).

150. See *Kieboom*, *ibid*. For an opposing view on the application of s. 69(1) in these circumstances, see *Shepp v. The Queen*, [1999] 1 C.T.C. 2889, 99 D.T.C. 510 (T.C.C.).

151. According to this provision, an avoidance transaction is defined as a transaction or series of transactions that, but for the GAAR, "would result, directly or indirectly, in a tax benefit, unless the transaction may reasonably be considered to have been undertaken or arranged primarily for *bona fide* purposes other than to obtain the tax benefit". Section 245(1) defines a tax benefit as "a reduction, avoidance or deferral of tax or other amount payable under this Act or an increase in a refund of tax or other amount under this Act".

or an abuse of the ITA as a whole as required by s. 245(4).¹⁵² Although at least one commentator concludes that the court's observation in *Neuman* that the ITA contains "no general scheme to prevent income splitting"¹⁵³ suggests that income-splitting arrangements are unlikely to constitute a "misuse" or "abuse" within the meaning of s. 245(4),¹⁵⁴ the existence of "an underlying philosophy that a taxpayer should not be able to divert income to another taxpayer for the purposes of reducing his or her marginal rate of tax"¹⁵⁵ makes this conclusion uncertain. Likewise, although it is arguable that the GAAR should not apply to income-splitting arrangements that are not caught by specific anti-avoidance rules directed at these arrangements;¹⁵⁶ this interpretive principle should apply only where the specific attribution rule explicitly exempts a particular form of income splitting.¹⁵⁷ Nonetheless, Revenue Canada appears to have concluded that the GAAR would not apply to "*Neuman*-type income-splitting arrangements".¹⁵⁸

Notwithstanding these existing rules, moreover the federal government has indicated a willingness to amend the ITA to limit some of the income-splitting opportunities otherwise made possible by the

152. According to this provision, the GAAR "does not apply to a transaction where it may reasonably be considered that the transaction would not result directly or indirectly in a misuse of the provisions of this Act or an abuse having regard to the provisions of this Act, other than this section, read as a whole".

153. *Neuman, supra*, footnote 10, at p. 187, citing Krishna and VanDuzer, *supra*, footnote 29, at p. 367.

154. Stephen W. Bowman, "Corporate Income Splitting Revisited: The Supreme Court Speaks" (1998), 46 Can. Tax J. 645 at p. 650. See also Krishna and VanDuzer, *ibid.*, at pp. 366-67, arguing that it would "be difficult for the Minister to establish that [an income-splitting] arrangement misuses a specific provision of the Act or that it is an abuse of the Act read as a whole".

155. Krishna and VanDuzer, *ibid.*, at p. 367.

156. See, e.g., Guy Fortin, "Abuse or Misuse", in *Report of the Proceedings of the Forty-Ninth Tax Conference, 1997 Conference Report* (Toronto: Canadian Tax Foundation, 1998), 5:1-22 at p. 3, citing a factum in *Outerbridge Estate, supra*, footnote 6, at p. 116, in which the court agreed with the taxpayer's view that:

There is a natural order to the provisions of the *Income Tax Act*, with technical rules . . . at the base, specific anti-avoidance rules like s. 56(2) one level higher, and the general anti-avoidance rule in section 245 at the apex. As a matter of assessment practice, a specific anti-avoidance rule should be resorted to only when a particular transaction is not caught by any technical rule, just as the general anti-avoidance rule should not be invoked except in the absence of a specific anti-avoidance rule.

157. See, e.g., T.E. McDonnell, "Tax Avoidance: Split(ting) Decision - Part 2" (1991), 39 Can. Tax J. 637 at p. 643, explaining that "the use of a discretionary dividend clause in a case involving a small business corporation should not be regarded as an abuse of the Act in view of the express provisions" of s. 74.4 allowing income splitting through transfers of property to small business corporations.

158. Revenue Canada, *Income Tax Technical News*, no. 16 (March 8, 1999).

decision in *Neuman*. Explaining that "recent case law has provided support for income-splitting techniques contrary to policy intent", the 1999 Federal Budget announced the introduction of "a targeted measure to discourage income splitting with minor children".¹⁵⁹ According to the budget, this new measure will involve a special "income-splitting tax" applying the top marginal tax rate instead of the normal graduated rates to certain kinds of income, including taxable dividends of private companies received by individuals under the age of 18.¹⁶⁰

Most interestingly, this proposal suggests an implicit policy decision to permit the use of discretionary dividends to split income with a spouse but not minor children. Indeed, such a policy may be justified on the grounds that adult spouses obtain effective control over the income to which they are legally entitled, making it properly taxable in their hands, while minor children are unlikely to exert effective control over income which they receive pursuant to an income-splitting arrangement.¹⁶¹ If this is the case, however, there is no justification for other spousal attribution rules, which should be repealed to permit spousal income splitting where legal title to income is effectively transferred. Where property is transferred to minor children, however, the logic of the new income-splitting tax suggests a more vigorous response than the current attribution rules, which apply to income from property lent or transferred to a related minor but not capital gains.¹⁶² One alternative, not unlike that employed in the United States, would be to tax all unearned income of minor children at the marginal rate of tax applicable to the income of one or the other parent.¹⁶³ This approach would be much simpler to administer than the current attribution rules, which require property to be traced to an attributable transferor, and is consistent with a plausible assumption that minor children exert little effective control over passive income which is not the product of their own efforts.

159. Martin, *The Budget Plan 1999, supra*, footnote 11, at p. 193.

160. In order to prevent double taxation, income that is subject to this income-splitting tax will be deductible in computing the individual's taxable income subject to the ordinary income tax.

161. For an excellent discussion of this control concept and its implications for policy decisions regarding the tax unit and income splitting, see Lawrence Zelenak, "Marriage and the Income Tax" (1994), 67 S. Cal. L. Rev. 339.

162. See *supra*, footnotes 143 and 146 and accompanying text.

163. See s. 1(g) of the Internal Revenue Code, which taxes certain unearned income of minor children at the parents' marginal rate.

2. Tax Avoidance

Beyond its specific application to income splitting, *Neuman* constitutes an important statement by the Supreme Court of Canada on judicial approaches to tax avoidance and anti-avoidance rules. First, as Iacobucci J. affirmed in the last of his general observations, "taxpayers can arrange their affairs in a particular way for the sole purpose of deliberately availing themselves of tax reduction devices in the ITA".¹⁶⁴ Second, he explained, "non-arm's length arrangements can also be created for the sole purpose of taking advantage of tax reduction devices".¹⁶⁵ Finally, he suggested, where the Minister relies on a specific anti-avoidance rule like s. 56(2), the provision can apply only where the statutory requirements to its application are "specifically met".¹⁶⁶

Although practitioners are likely to welcome the first and second of these comments as a reaffirmation of the traditional principle that "[e]very man is entitled if he can to order his affairs so as that the tax attaching under the appropriate Acts is less than it otherwise would be",¹⁶⁷ a note of caution is in order. Since the enactment of the GAAR was specifically intended to limit this principle,¹⁶⁸ the court's affirmation of this principle may be limited by the fact that the GAAR did not apply to the years at issue in *Neuman*. On the other hand, as one commentator has suggested, if the court's comments foreshadow its approach to the GAAR, "they suggest an extremely narrow interpretation".¹⁶⁹

A similar comment may be made with respect to the court's observation that s. 56(2) can apply only where the various requirements to its application are "specifically met". Although directed at the interpretation of s. 56(2), this statement may suggest a more

164. *Neuman*, *supra*, footnote 10, at p. 188.

165. *Ibid.*

166. *Ibid.*, at p. 187.

167. *The Commissioners of Inland Revenue*, [1936] A.C. 1 (H.L.) at p. 19, *per* Lord Tomlin. For an example of this enthusiasm, see Catherine A. Brayley, "Life Pending *Neuman*" in *Report of the Proceedings of the Forty-Ninth Tax Conference*, 1997 Conference Report (Toronto: Canadian Tax Foundation, 1998), 15:1-21 at p. 21.

168. See Department of Finance, *Income Tax Reform 1987* (June 18, 1987), reproduced in *White Paper on Tax Reform* (Don Mills, CCH, 1987), p. 95 at p. 211, signalling a "change in direction" involving the introduction of a new general anti-avoidance rule "intended to strike a balance between taxpayers' need for certainty in planning their affairs and the government's responsibility to protect the tax base and the fairness of the tax system" by "establish[ing] limits to acceptable tax avoidance".

169. Daniel Sandler, "A Wake for *McClurg Dicta*" (1998), 6 *Can. Tax Highlights* 41.

general view according to which specific anti-avoidance rules should be construed narrowly in favour of the taxpayer. If so, this statement would appear to contradict the modern trend against strict construction of taxing statutes.¹⁷⁰

3. Statutory Interpretation

With respect to statutory interpretation more generally, the court's approach in *Neuman* is curious. Although recent tax cases have placed primary emphasis on the words of the statutory text, whether in the form of the "plain meaning rule" or the "words-in-total-context approach",¹⁷¹ the interpretive approach to which the court refers in *Neuman* is largely purposive or teleological, emphasizing the purpose of s. 56(2) much more than the words of the provision. Moreover, by considering the practical consequences of alternative interpretations, the court acknowledges a category of relevant considerations that is absent from any of the interpretive doctrines to which the court actually refers.¹⁷² In this respect, as I have argued elsewhere, the court's interpretive approach is implicitly pragmatic, considering a variety of relevant factors including the practical consequences of different interpretations in addition to

170. The traditional rule according to which taxing statutes should be strictly construed in favour of the taxpayer was questioned in *Stubart*, *supra*, footnote 37, and decisively rejected in *Golden v. The Queen*, [1986] 1 C.T.C. 274 at p. 277, 86 D.T.C. 6138 (S.C.C.), stating that: "strict construction in the historic sense no longer finds a place in the canons of interpretation applicable to taxation statutes". On the decline of strict construction, see Duff, "Interpreting the *Income Tax Act* - Part I: Interpretive Doctrines" *supra*, footnote 76, at pp. 482-85.

171. See, e.g., *Antosko v. The Queen*, *supra*, footnote 37, at p. 31, *per* Iacobucci J., stating that: "While it is true that the courts must view discrete sections of the *Income Tax Act* in light of the other provisions of the Act and of the purpose of the legislation, and that they must analyze a given transaction in the context of economic and commercial reality, such techniques cannot alter the result where the words of the statute are clear and plain and where the legal and practical effect of the transaction is undisputed"; and *Alberta (Treasury Branches) v. The Queen*, [1996] 1 C.T.C. 395 at pp. 403-404, 96 D.T.C. 6245 (S.C.C.), *per* Cory J., affirming a "words-in-total-context approach" giving priority to the words of the statutory text but affirming that "in order to determine the clear and plain meaning of the statute it is always appropriate to consider the 'scheme of the Act, the object of the Act, and the intention of Parliament'". For a detailed review of these doctrines and leading tax cases in which they have been applied, see Duff, "Interpreting the *Income Tax Act* - Part I: Interpretive Doctrines" *supra*, footnote 76, at pp. 504-32.

172. Neither the plain meaning rule, nor the teleological approach, nor the words-in-total-context approach make explicit reference to the role of consequential considerations in statutory interpretation.

the text of the Act, the scheme of the Act, the purpose of the Act, and the intentions of the legislature.¹⁷³

Notwithstanding this apparent pragmatism, however, it is arguable that the court's strict approach to the interpretation of s. 56(2) was shaped less by its purposive and consequential analyses, the conclusions of which are questionable in any event,¹⁷⁴ than by a traditional presumption, reflected in its view that this provision can apply only where its terms are "specifically met",¹⁷⁵ that tax statutes should be strictly construed in favour of the taxpayer. If this is so, the decision is as troubling for the interpretation of tax statutes generally as it is for the interpretation of specific anti-avoidance rules and the GAAR. While strict construction of taxing statutes has a lengthy history in Canadian tax law,¹⁷⁶ it has been sharply criticized by academics and practitioners alike,¹⁷⁷ and explicitly rejected by the Supreme Court of Canada on several occasions.¹⁷⁸ To restore such a presumption implicitly would be to ignore these criticisms and reverse these decisions without even so much as an argument.

V. CONCLUSIONS

Notwithstanding the many concerns that this article has expressed regarding the Supreme Court of Canada decision in *Neuman*, practitioners are likely to welcome the decision on the

173. Duff, "Interpreting the *Income Tax Act* - Part I: Interpretive Doctrines", *supra*, footnote 76. For a more general discussion of this implicit pragmatism in Supreme Court of Canada decisions involving the interpretation of statutory provisions, see Ruth Sullivan, "Statutory Interpretation in the Supreme Court of Canada" (1998-99), 30 *Ottawa L. Rev.* 175.

174. See the analysis at *supra*, footnotes 85 to 134 and accompanying text.

175. *Neuman*, *supra*, footnote 10, at p. 187.

176. See the discussion of strict construction in Duff, "Interpreting the *Income Tax Act* - Part I: Interpretive Doctrines", *supra*, footnote 76, at pp. 469-85.

177. See, e.g., John Willis, "Statute Interpretation in a Nutshell" (1938), 16 *Can. Bar Rev.* 1 at pp. 25-27; W. Friedmann, "Statute Law and Its Interpretation in the Modern State" (1948), 26 *Can. Bar Rev.* 1277 at pp. 1298-299; Douglas J. Sherbaniuk, "Tax Avoidance - Recent Developments," in *Report of the Proceedings of the Twenty-First Tax Conference*, 1968 Conference Report (Toronto: Canadian Tax Foundation, 1969), p. 430; and Stephen Bowman, "Interpretation of Tax Legislation: The Evolution of Purposive Analysis" (1995), 43 *Can. Tax J.* 1167. These arguments are reviewed in Duff, "Interpreting the *Income Tax Act* - Part II: Towards a Pragmatic Approach", *supra*, footnote 71.

178. See, e.g., *Golden v. The Queen*, *supra*, footnote 170, at p. 277; *Bronfman Trust v. The Queen*, [1987] 1 *C.T.C.* 117 at p. 128, 87 *D.T.C.* 5059 (S.C.C.); *McClurg*, *supra*, footnote 6, at pp. 182-83; *Corporation Notre-Dame de Bon-Secours v. Québec*, *supra*, footnote 87, at p. 249; and *Schwartz v. The Queen*, [1996] 1 *C.T.C.* 303 at p. 331, 96 *D.T.C.* 6103 (S.C.C.).

grounds that it has eliminated much of the uncertainty created by *McClurg*, reaffirmed the traditional principle that taxpayers may arrange their affairs for the sole purpose of avoiding tax, adopted a strict approach to the interpretation of specific anti-avoidance provisions and opened the door to sophisticated income-splitting techniques through the use of discretionary dividends. While the ITA contains other provisions that may be applied to challenge these income-splitting arrangements, it remains to be seen whether the Minister will attempt to invoke these rules, and how the courts will respond to these efforts. To the extent that *Neuman* signals a broad acceptance of tax avoidance transactions and a narrow approach to the interpretation of anti-avoidance rules, however, the Minister's prospects are uncertain.

Not surprisingly, therefore, the federal government has responded, as it has time and time again since the *Income War Tax Act* was enacted in 1917,¹⁷⁹ by proposing specific statutory amendments to reverse judicial decisions "contrary to policy intent".¹⁸⁰ Most interestingly, however, by targeting only "those structures that are primarily put in place to facilitate income splitting with minors",¹⁸¹ the government appears to have accepted the use of discretionary dividends to split income with one's spouse. Although the logic of this policy choice favours the enhancement of attribution rules for minor children and the repeal of all spousal attribution rules, it remains to be seen whether the decision in *Neuman* will prompt yet further amendments to the scheme of the ITA.

179. S.C. 1917, c. 28.

180. Martin, *The Budget Plan 1999*, *supra*, footnote 11, at p. 193.

181. *Ibid.*, at p. 194.