Tax Issues in Business Disputes

Helping Your Client Achieve a Better After-Tax Result

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ABSTRACT

At the start of a business venture, tax plans are often meticulously-laid to ensure each side to the deal maximizes the after-tax return of each dollar spent or received. When disputes arise however, the parties may lose sight of tax issues and dollars and thereby miss opportunities to engineer a tax-efficient resolution or exit. With a proactive approach by corporate and litigation counsel, the client may be better-positioned earlier in the litigation/resolution process to achieve a more favourable net result while avoiding unanticipated tax costs.

INTRODUCTION[1]

> Unless the ITA provides otherwise, a taxpayer is entitled to be taxed based on what it actually did, not based on what it could have done, and certainly not based on what a less sophisticated taxpayer might have done.[2]

In every business venture, government is the obligatory silent partner. The profit-sharing plan with that partner is regulated under the *Income Tax Act* (Canada) (the "ITA"), and as such can be predicted in advance, and minimized through planning. At the beginning of the venture, close attention is often paid to that silent partner, with careful structuring and planning put in place to ensure it receives no more than the minimum of its due profits.

Tax planning on the exit is just as important as it is at the deal stage, in terms of best financial outcomes for your client. Modeling potential cost/benefit scenarios on the dollar amount paid or received by either party will avoid the surprise of hidden costs and benefits to either side in litigation or settlement. Failure to tax plan early on can lead to unintended tax consequences that are difficult, if not impossible to remedy after the fact. Potentially and ideally, there may be win-win solutions whereby careful structuring results in an application of the tax rules for the benefit of all, thereby potentially paving the pathway for settlement.

This paper is divided into three parts. Part I reviews certain rules on taxation of corporations and shareholders, applied in the context of a hypothetical shareholder dispute that culminates in a shareholder buy-out, to show the results that can arise with different planning options and outcomes. Part II reviews the tax treatment of damages and settlement amounts, focusing on the tax treatment to the recipient of such amounts. Part III considers the tax treatment of various expenses that might be incurred in the course of a business or employment dispute, or to protect various business interests, and how best to position your client in advance to obtain the most favourable tax treatment possible in respect of such expenses. All references to the "ITA" are references to the *Income Tax Act* (Canada)[3]. In addition, for the purposes of this paper any modeling assumes tax at the highest marginal rate, applicable at the date of writing, without taking into consideration graduated tax brackets or the resulting effective tax rate that could result from applying these.

[1] The Author gratefully acknowledges the assistance of colleague Tony Vacca and Matt Sharp of GGT Chartered Accountants in reviewing and providing valuable feedback in the preparation of this paper.

[2] *Jean Coutu Group (PJC) Inc. v. Canada (Attorney General),* 2016 SCC 55, [2016] S.C.R. 670 at par 41, citing the principle from *CIR v. Duke of Westminster*, [1936] AC 1, affirmed by the Supreme Court of Canada many times.

[3] RSC 1985, c.1 (5th Supp.) as amended.

PART I - SHAREHOLDER DISPUTE: TAX AND DEPARTURE OF A SHAREHOLDER

Often the resolution in a shareholder dispute is departure of one or more shareholders. Where that shareholder's interest is bought out, a critical first question is the choice of entity that will purchase the shares. While there may be a unanimous shareholder agreement that provides some guidance, it may not prescribe specific transaction steps, leaving room for dispute - or put more optimistically - planning. The after-tax results to both the purchaser and departing shareholder will depend on various deal structuring options. In certain cases, the shareholder may have options between realizing a capital gain, a deemed dividend, or a deferral of tax. The funding and after-tax results to the purchaser will also depend on various options established in part through negotiations or litigation.

INDIVIDUAL SHAREHOLDER

As a general rule, when a corporation buys back shares from a shareholder, any amount paid in excess of the paid-up capital ("PUC")[4] of the redeemed shares is deemed a dividend, subject to dividend tax rates in the hands of the individual.[5] Depending on applicable tax rates, the difference between the tax paid on a capital gain versus that paid on a dividend can be significant, with a capital gain currently being substantially more advantageous in most circumstances.[6] For this reason, a departing shareholder will generally prefer to have shares purchased by other shareholders or an arm's-length corporation (rather than having them redeemed), thereby subjecting the proceeds to capital gains rates and possibly rendering the gain eligible for the lifetime capital gains exemption.

CORPORATE SHAREHOLDER

Shareholding structures that involve holding companies ("Holdco") as shareholders are fairly common, as these may allow after-tax corporate profits to be distributed as tax-free dividends to the corporate shareholder, or Holdco. [7]

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[4] In very general terms, this concept recognizes and allows for the tax-free return of the initial investment made with tax-paid funds.

[5] Subsection 84(3) of the ITA.

[6] Capital gains are, due principally to the current ½ inclusion rate, generally more efficient. Specific rates are subject to change and therefore are not cited in this paper.

[7] Very generally, under subsection 55(2) of the ITA, for dividends received after April 20, 2015 the dividends must be within both the amount of "safe income" and the accrued but unrealized gain on the shares on which the dividend is paid. See subparagraph 55(2.1)(c).

Tax-Free Sale Proceeds

Where circumstances permit, all or a portion of sale proceeds paid by the operating company ("Opco") to Holdco may be received by Holdco in the form of a tax-free dividend, with tax payable only on subsequent distributions to shareholders.[8] This type of structuring allows the departing shareholder to defer tax and reinvest sale proceeds instead, where circumstances permit. Advance planning is required to achieve such result.

Trigger Capital Gain

In certain circumstances and with appropriate advance planning, where Opco purchases shares from a Holdco shareholder, the proceeds to Holdco may be treated as a capital gain rather than a deemed dividend.[9] If the purchase proceeds are not reinvested by Holdco but rather fully distributed to Holdco's shareholder's, the after-tax proceeds to the individual shareholder may be considerably lower in such cases.

ALL SHAREHOLDERS - TAX POOLS

The tax attributes of a corporation form part of the intrinsic value of the shares, and allocation of these attributes or pools to a departing shareholder can significantly change the tax result to a shareholder receiving a dividend. Accordingly, these tax attributes should be factored in to structuring discussions. Tax accounts and tax pools are notional amounts or accounts that can be allocated to shareholders on payments from the corporation. Amounts and accounts that are commonly considered in structuring a sale include the following:

- capital dividend account ("CDA") – allows for payment of tax-free dividends to shareholders
- general rate income pool ("GRIP") – dividends paid are subject to lower tax rates to shareholders

[8] *Ibid.*

[9] The rules at subsection 55(2) of the ITA are complex. In very general terms, a redemption of shares held by a corporate shareholder as part of the series of transactions that results in changes to the shareholdings of a corporation may be recharacterized as proceeds of disposition (as opposed to a dividend) to the extent there is insufficient safe income attributable to the redeemed shares or the dividend exceeds any unrealized gain on the shares, in certain circumstances. However, depending on applicable tax rates, this may actually result in lower overall tax upon full distribution of proceeds to the individual shareholder. A discussion of such planning is beyond the scope of this paper.