Docket: 2010-1826(IT)I

BETWEEN:

MINHONG YANG,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

Appeal heard on January 13, 2011, at London, Ontario

Before: The Honourable Justice G. A. Sheridan

Appearances:

Agent for the Appellant:	Hui Zhu
Counsel for the Respondent:	Hong Ky (Eric) Luu

JUDGMENT

The appeal from the reassessment made under the *Income Tax Act* for the 2007 taxation year is dismissed in accordance with the attached Reasons for Judgment.

Signed at Ottawa, Canada, this 6th day of April 2011.

"G. A. Sheridan"

Sheridan J.

Citation: 2011TCC187
Date: 20110406
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MINHONG YANG,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

REASONS FOR JUDGMENT

Sheridan J.

[1] The issue in this appeal is whether the Minister of National Revenue properly included in income the fair market value of shares distributed to the Appellant, Minhong Yang, by a Bermuda-based corporation known as Tyco International Ltd. ("Tyco International") following a reorganization of its holdings in 2007.

[2] On January 13, 2006, the board of directors of Tyco International approved the spin-off of its electronics and healthcare business operations to its wholly owned subsidiaries, Tyco Electronics Ltd. ("Tyco Electronics") and Covidien Ltd. ("Covidien"), respectively, retaining for itself its fire, security, engineered products and services business. All went as planned and on June 29, 2007, Tyco International distributed its shares in Tyco Electronics and Covidien to its shareholders, one of whom was the Appellant.

[3] Further details are set out in the facts assumed and additional material facts alleged by the Minister of National Revenue at paragraphs 7 and 8 of the Reply to the Notice of Appeal:

> 7. In determining the Appellant's tax liability for the 2007 taxation year, the Minister made the following assumptions of fact:

(a) the Appellant owned 464 shares of Tyco International Ltd. in 2007;

(b) the Appellant received a stock distribution from Tyco International Ltd. in 2007 consisting of:

i) 116 shares of Tyco Electronics Ltd; and

ii) 116 shares of Covidien Ltd.

(c) at the time, the fair market value of the Tyco International Ltd. shares received by the Appellant was $10,248 ($9,535.20 US);

(d) at all material times, Tyco International Ltd., Tyco Electronics Ltd. and Covidien Ltd. were incorporated under the laws of Bermuda;

(e) at all material times, Tyco International Ltd., Tyco Electronics Ltd. and Covidien Ltd. were not residents of the United States of America;

(f) at all material times, Bermuda did not have a tax treaty with Canada;

(g) the appellant received other distributions of dividends from foreign corporations in the amount of $837 ($778.66 US);

(h) in her return of income filed for the 2007 taxation year, the Appellant understated her income for that year by the amount of $11,085 ($10,313.86 US);

(i) Tyco International Ltd. did not, at any time, provide the Minister with the information required by paragraph 86.1(2)(e) of the *Income Tax Act*, R.S.C. 1985, c.1. (5th Supp.), as amended (the "*Act*"), with respect to the distribution of the shares of Tyco Electronics Ltd. and Covidien Ltd. to its shareholders.

8. He relies on the following additional material facts:

(a) on January 13, 2006, the board of directors of Tyco International Ltd. approved a plan to spin off:

i) Tyco International Ltd.'s electronics business into a new corporation called Tyco Electronics Ltd; and

ii) Tyco International Ltd.'s health care business into a new corporation called Covidien Ltd.;

(b) after the spin-off of its electronics and health care business into Tyco Electronics Ltd. and Covidien Ltd. respectively, Tyco International Ltd. continued to carry on its fire, security, engineered products and services business;

(c) Tyco International Ltd., Tyco Electronics Ltd. and Covidien Ltd. are not resident in Canada;

(d) on June 29, 2007 Tyco International Ltd. distributed, as a dividend in kind, its shares in Tyco Electronics Ltd. and Covidien Ltd. to its shareholders;

(e) as a result of Tyco International Ltd.'s dividend in kind on June 29, 2007, each of its shareholders received a distribution consisting of:

i) 0.25 shares of Tyco Electronics Ltd. for each share of Tyco International Ltd.; and

ii) 0.25 shares of Covidien Ltd. for each share of Tyco International Ltd.

(f) Tyco International Ltd. owned all the shares of Tyco Electronic Ltd. and Covidien Ltd. immediately prior to their distribution to its shareholders;

[4] The Minister characterized Tyco International's distribution of its Tyco Electronics and Covidien shares as a "stock distribution" and treated such shares as a "dividend in kind" received by the Appellant from a non-resident corporation. Because Bermuda does not have a tax treaty with Canada, the distribution of the shares did not qualify as an "eligible distribution" under paragraph 86.1(2)(*d*) and accordingly, the Minister included the fair market value of the shares in the Appellant's income pursuant to subsections 52(2) and 90(1) and paragraph 12(1)(*k*) of the *Act*.

[5] The Appellant concedes that section 86.1 has no application to her case but argued that the Tyco Electronics and Covidien shares ought not to be treated as income because she did not, as a matter of fact, receive anything of value as a result of the distribution. Her agent and husband, Hui Zhu, argued that the Tyco Electronics and Covidien shares were merely a replacement of existing capital property, that is to say, of the Tyco International shares held prior to the June 29, 2007 reorganization. In fact, he said, immediately after the distribution, the value of the Appellant's holdings decreased slightly. In such circumstances, queried Mr. Zhu, what factual or logical basis could there be for treating the Tyco Electronics and Covidien shares as income?

[6] The same question was posed with the same degree of incensed bewilderment in *Hamley v. Canada*, 2010 TCC 459 and *Capancini v. Canada*, 2010 TCC 581, appeals of two other taxpayers similarly affected by Tyco International's reorganization. As in the present case, the appeals were heard under the Informal Procedure and the taxpayers were not represented by counsel. In *Hamley*, the

taxpayer's appeal was dismissed; in *Capancini*, the appeal was allowed. This divergence in outcomes can be traced to the different findings of fact in each case. In his oral judgment in *Hamley*, Hershfield, J. found that:

> [3] The admitted facts or facts established … the following findings. One, the distribution by Tyco was part of a reorganization of its holdings whereby two of its business operations were, in common corporate finance and tax jargon, spun-off to two separate corporate entities in such a manner as to make it, Tyco, the recipient of shares in such separate entities. These shares were then distributed to Tyco shareholders.[1]

[7] Based on these findings, the Court concluded that:

> [12] The stock distributions in question then were dividends in kind that had value and the value is income from property and taxable. …. as dividends from a foreign corporation, they are specifically covered by paragraph 12(1)(k) and section 90 of the *Act* and must be included in income under those provisions as set out in the respondent's written submissions and book of authorities.[2]

[8] In *Capancini*, Bowie, J. summarized the facts arising from the Tyco International reorganization as follows:

> [2] Prior to June 29, 2007 Mr. Capancini owned 225 shares of Tyco International Ltd. (Tyco I), a large and diversified corporation with its head office in Bermuda and operating in the United States and elsewhere. On that date, Tyco I underwent a reorganization that involved spinning off two segments of its business to new corporations, Tyco Electronics Ltd. (Tyco E) and Covidien Ltd., together with a reverse stock split. Tyco E and Covidien were also incorporated under the laws of Bermuda. Under this reorganization Tyco I shareholders each received one Tyco E share, one Covidien share, and one new Tyco I share for each four old Tyco I shares that they held. For fractions over a multiple of four they received a cash payment. The appellant, therefore, received 56 Tyco E shares, 56 Covidien shares, 56 new Tyco I shares and a small cash payment in place of his 225 old Tyco I shares.[3]

[9] After reviewing the jurisprudence, in particular, *Morasse v. R.*, 2004 TCC 239, Bowie, J. allowed the appeal on the following basis:

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[1] At paragraph 3.

[2] At paragraph 12.

[3] Paragraph 2.

> [13] *Morasse v. R.*[4] is a case in which the facts were indistinguishable from the case before me. The taxpayer was the owner of 400 shares of a Mexican corporation which underwent a reorganization whereby a distinct part of the business of the corporation was spun off to a new corporation. The assets and the liabilities relating to that part of the business of the original company became the assets and liabilities of the new company. Each shareholder received one share of the new company for each share held in the original company. As in this case, the appellant's broker described the shares of the new company as a stock dividend and issued a T5 form for the market value of the shares on the date of issue. Miller J. held that that was not determinative of the issue. I agree with that, and I agree with his conclusion that in these circumstances the new shares are not a stock dividend, because they are not shares of the original company. Nor are they a dividend in kind, as is the case when a wholly owned subsidiary is spun off by a distribution of its shares to shareholders of the parent company. In this case the shares of Tyco E and Covidien were never owned by Tyco I. They were created in the course of a reorganization, and together with the new Tyco I shares they simply comprise the original capital of Tyco I in a different form.[5] [Emphasis added.]

[10] Quite understandably, Mr. Zhu contended that the Appellant's case was on all fours with *Capancini*. In support of his argument, he put in evidence a booklet of documents relating to the Tyco International reorganization marked as Exhibit A-1. Unfortunately, many of these are only a few loose pages from other documents. I do not fault Mr.Zhu for this; he is not a lawyer, the matter was heard under the Informal Procedure and many of the documents concerned are quite voluminous. It is common ground, however, that the relevant documents relied on by the Appellant are part of an informational package prepared by Tyco International for the purpose of explaining to its shareholders how the proposed reorganization would work. According to the information in Tabs 2 and 4 of Exhibit A-1, Tyco Electronics and Covidien were wholly owned subsidiaries of Tyco International which had been incorporated in Bermuda in 2000. The transactions leading up to the June 29, 2007 distribution of Covidien and Tyco Electronics shares are described as follows:

> … As part of a plan to separate Tyco International into three independent companies, Tyco International transferred the equity interests of the entities that held all of the assets and liabilities of its healthcare businesses to Covidien and, on June 29, 2007, distributed all of its [Tyco International's] shares of Covidien to its shareholders. [Emphasis added.]

[11] These descriptions are consistent with statements in the Minister's documents, Exhibits R-1, R-2 and R-3.

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[4] Original footnote deleted from the text.

[5] Paragraph 13.

[12] Exhibit R-1 is a Tyco International press release dated approximately three weeks before the proposed distribution which announces, among other things, that:

> … In connection with the dividend distribution, each Tyco International shareholder will receive one common share of Covidien Ltd. and one common share of Tyco Electronics for every four common shares of Tyco International held at the close of business on [June 29, 2007]. … Immediately following the distributions, Tyco International's shareholders will own 100% of the common shares of Covidien and Tyco Electronics.
>
> The distributions have been structured to qualify as tax-free dividends to Tyco International shareholders for U.S. federal income tax purposes. … Shareholders are urged to consult with their tax advisors as to the specific consequences of the distribution to such shareholder. … Immediately following the distributions, every four common shares of Tyco International will be converted into one common share of Tyco International.

[13] Exhibit R-2, briefly summarized, is a decision of the "local securities regulator" for various Canadian provincial jurisdictions following a request for certain relief by Tyco International in respect of the proposed distribution. At paragraph 4.2 of that document, Tyco International represented that prior to the spin-off, Tyco Electronics and Covidien were its wholly owned subsidiaries. In paragraphs 1.1 and 1.2, Tyco International stated that the proposed distribution of "its" Tyco Electronics and Covidien common shares to Tyco International shareholders resident in Canada would be "by way of a pro rata dividend in kind"[6].

[14] Exhibit R-3 is a complete copy of the "Separation and Distribution Agreement" between Tyco International, Covidien and Tyco Electronics, the same document to which frequent reference is made in Exhibit A-1. The third paragraph of the preamble to that agreement sets out the decision of the Board of Directors of Tyco International "to distribute to the holders of [Tyco International] Common Stock on a pro rata basis … all of the outstanding shares of common stock … of … [Covidien] and … [Tyco Electronics]".

[15] All of the above works to distinguish the facts of the present matter from *Capancini* and *Morasse* where, in each case, the Court found that the shares received by the taxpayer had never been owned by the distributing parent company and did not, therefore, come within the meaning of "dividend in kind". Here, the documentary evidence does nothing to refute the Minister's assumption that Tyco International did own the Tyco Electronics and Covidien shares it ultimately distributed, thus putting the Appellant's case on the same factual footing as *Hamley*

[6] Exhibit R-2 at paragraphs 1.1 and 1.2.

and bringing it within Justice Hershfield's analysis set out above at paragraph 7 of these Reasons. In these circumstances, there is no justification for the Court to interfere with the Minister's reassessment.

[16] In reaching this conclusion, I am mindful of how unfair and illogical the Appellant (and more particularly, her agent, Mr. Zhu) will consider it to be. In addressing similar sentiments raised by the unsuccessful taxpayer in *Hamley*, Hershfield, J. offered the following explanation which, though perhaps of little comfort, summarizes the working of the legislation:

> Regrettably for the appellant, notwithstanding her logic, this is not the way the system works. The *Act* does not … work on the theory that a simple change in form of a holding is not a taxable event. Indeed, it works on the theory that every change in holdings that gives you something different than you had before is a taxable event, even if your net economic position has not changed and you have not received actual dollars to suggest that you really received something of value.
>
> … this gives Parliament control over exceptions it deems appropriate from a number of possible perspectives including, for example, a tax theory perspective, an economic incentive perspective or a prevention-of-tax-slippage perspective particularly in an international or tax-haven context or as part of a perspective that is simply a policing perspective.
>
> In the case of foreign spun-off reorganizations, and resultant distributions of shares in the spun-off entities that are treated as dividends, the *Act* has made no exception to the general rule of taxing the receipt in the same way it would tax a cash distribution except for those exceptions that I have already dealt with as set out in section 86.1, which do not apply here as the requirements for those exceptions have not been met in many respects.[7]

[7] Paragraphs 16, 17 and 18.

[17] The appeal of the reassessment of the Appellant's 2007 taxation year is dismissed.

Signed at Ottawa, Canada, this 6th day of April 2011.

"G. A. Sheridan"

Sheridan J.

CITATION:	2011TCC187
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APPEARANCES:

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