Docket: 2022-3096(IT)G

BETWEEN:

KATHRYN J CARTER,

Appellant,

and

HIS MAJESTY THE KING,

Respondent.

Appeals heard on April 30 and May 1, 2024,
at Fredericton, New Brunswick

Before: The Honourable Justice David E. Graham

Appearances:

Counsel for the Appellant:	John Loukidelis
Counsel for the Respondent:	Allan Mason Shane Isler

JUDGMENT

The appeals of the reassessments of the Appellant's 2015, 2016, 2017 and 2018 taxation years are vacated.

Costs are awarded to the Appellant. The parties shall have until June 17, 2024 to reach an agreement on costs, failing which the Appellant shall have until July 17, 2024 to serve and file written submissions on costs and the Respondent shall have until July 29, 2024 to serve and file a written response. Any such submissions shall not exceed 10 pages in length. If the parties do not advise the Court that they have reached an agreement and no submissions are received within the foregoing time limits, costs shall be awarded to the Appellant as set out in the Tariff.

Signed at Ottawa, Canada, this 16th day of May 2024.

"David E. Graham"

Graham J.

Citation: 2024 TCC 71
Date: 20240516
Docket: 2022-3096(IT)G

BETWEEN:

KATHRYN J CARTER,

Appellant,

and

HIS MAJESTY THE KING,

Respondent.

REASONS FOR JUDGMENT

Graham J.

[1] These appeals concern the application of section 84.1 of the *Income Tax Act* to the sale of shares in a family business.

[2] The only issues are whether the Appellant dealt at arm's length with the company that purchased her shares in the family business at the time of the purchase and whether the purchasing company was connected to the family business immediately after that purchase.

[3] I will first set out the background that gave rise to the transactions in issue, then describe those transactions and finally analyze whether section 84.1 should apply.

I. **Background**

A. History of the Company

[4] Brown's Paving Ltd. ("BPL") carries on a paving business in New Brunswick. The business was started by the Appellant's grandfather and has been passed down through the generations since 1957.

[5] Following her grandfather's death, BPL passed to the Appellant's father, Wallace Brown, and her uncle, Calvin Brown. Following Calvin Brown's death in the late 1990s, Wallace Brown became the sole shareholder of BPL.

B. Bringing in the Next Generation

[6] Around that time, Wallace Brown brought his nephew, Corey McAllister, into the business. Mr. McAllister is the son of one of Wallace Brown's sisters. Calvin Brown had handled the sales and estimates side of the business. That was not one of Wallace Brown's strengths and he wanted to bring in someone who could fill that roll. Mr. McAllister had recently graduated from a college civil engineering program, had previously worked for BPL and had work experience in asphalt testing. Wallace Brown felt that Mr. McAllister would be an asset to the business.

[7] Around this same time, the Appellant, who was in high school, began working for BPL. As was her father's wish, the Appellant started at the bottom with the plan of experiencing every aspect of the business.

[8] While in high school, the Appellant worked summers, first as a road flagger on a patching crew and later as a labourer. After graduation, she began working full-time for BPL as a heavy equipment operator. The Appellant told her father that she wanted to eventually take over the business.

[9] To better position herself for the future, the Appellant enrolled in a two-year business program. She continued working at BPL in the summers and returned to working there full-time after she graduated. At that point she began running a patching crew and doing job estimates. She used her new business knowledge to help her father better track BPL's assets and better understand the company's finances.

[10] The Appellant eventually determined that a degree from a two year civil engineering program focusing on the types of work that BPL did would benefit her. Mr. McAllister had a similar degree and the Appellant could see its benefits. While she pursued that degree, she worked for BPL during the intervening summer. She returned to BPL full-time after she graduate in 2005. Her duties then expanded to include road surveying, soil sampling and testing and the implementation of a company-wide safety program to ensure compliance with new government regulations.

C. Stake in the Future

[11] In 2007, both Mr. McAllister and the Appellant independently spoke to Wallace Brown about taking an ownership stake in BPL.

[12] Mr. McAllister expressed that he had been with BPL for about 10 years and wanted to be a part of the company's future. He pushed Wallace Brown to let him buy shares.

[13] The Appellant reaffirmed to her father that she would like to eventually take over the business. He expressed to the Appellant that he was pleased with that idea but felt that the Appellant would benefit from Mr. McAllister's continuing involvement. He proposed issuing shares to both of them.

D. Estate Freeze

[14] As a result of these conversations, in 2007, Wallace Brown entered into an estate freeze whereby he exchanged his common shares of BPL for Class B non-voting preferred shares redeemable for an amount equal to the fair market value of BPL at the time of the freeze and 1,000 Class A voting preferred shares.

[15] On the same day, Wallace Brown, the Appellant and Mr. McAllister subscribed for 20 Class A common shares, 40 Class B common shares and 40 Class C common shares respectively.

[16] While Wallace Brown gave up much of his stake in the future growth of BPL, as a result of his voting preferred shares, he continued to control the company.

E. Significant Growth

[17] By 2013, BPL had undergone significant growth. At the Appellant's and Mr. McAllister's insistence, the company had made substantial investments in additional equipment and had approximately doubled its workforce. As a result, it had also doubled its revenues.

[18] Just as Mr. McAllister's and the Appellant's involvement in the business had grown, Wallace Brown's involvement had significantly decreased. He was essentially semi-retired. He was still interested in doing the work he liked such as equipment maintenance but had little interest in managing the business.

II. **The Transactions**

A. Desire for Change

[19] By early 2014, BPL was facing increased price competition. Mr. McAllister believed that the company needed to control its costs. He felt that the Appellant's heart was no longer in the business and recognized that BPL would have more financial flexibility if it did not have to pay the Appellant a share of the profits.

[20] In late 2014, Mr. McAllister approached the Appellant about buying her shares. The Appellant was surprised. She had not thought about selling her shares. She told Mr. McAllister that she would think about it.

[21] In 2008, the Appellant had begun dating the man who would eventually become her husband. He lived in a different town, about 60 to 90 minutes away from BPL. The Appellant moved in with him in 2010 and began what turned into years of very early mornings and long commutes to work. The couple married in 2013.

[22] Although the Appellant had not thought about selling her shares, on reflection, the idea appealed to her. She enjoyed her work at BPL but not the commute. She and her husband wanted to eventually start a family and she was unsure whether she would be able to balance that against the demands of the business.

B. Negotiations

[23] The Appellant offered to sell her shares to Mr. McAllister for $800,000. Mr. McAllister told her that he had been thinking of offering something closer to $250,000 although he testified that, in his mind, he expected a price of somewhere between $300,000 and $500,000. Eventually, they agreed to have the company valued.

[24] Both the Appellant and Mr. McAllister sought Wallace Brown's approval of the buyout (both on a personal level and because he had a right of first refusal). However, Wallace Brown stayed out of the negotiations.

[25] Ultimately, the Appellant and Mr. McAllister agreed to a price of $600,000. The Appellant accepted this price on the conditions that she receive full payment on closing and that the sale be structured in a manner that allowed her to use her capital gains exemption to shelter her gains.

C. With What Money?

[26] Mr. McAllister did not have the money to buy the Appellant's shares. He knew that the money would have to be borrowed. He wanted to ensure that the interest on that loan would be deductible.

D. Professional Advice

[27] The Appellant and Mr. McAllister decided that they would use BPL's lawyer to document the share sale. At their lawyer's suggestion, they retained an accounting firm to provide tax advice.

[28] The accounting firm explained that there were different ways to structure the transaction. They recommended a series of transactions that would meet both the Appellant's and Mr. McAllister's goals.

E. Introduction of Corco

[29] In December 2014, Mr. McAllister rolled all of his shares in BPL to a newly formed holding company named Corco Holdings Inc. ("Corco"). Mr. McAllister was the sole shareholder of Corco.

[30] While Corco plays an important part in the tax plan, I find that Mr. McAllister was already in the process of creating a holding company for personal tax purposes and would have created one to hold his shares even if the purchase of the Appellant's shares had not gone through.

F. Transactions in Issue

[31] The transactions in issue are relatively straight-forward.

[32] In late February 2015, BPL borrowed $600,000 from a bank. BPL gave the bank a charge over all of its assets. Mr. McAllister and Corco guaranteed the loan and Corco pledged its shares in BPL as security. Wallace Brown did not guarantee the loan.

[33] In early March, Corco purchased all of the Appellant's shares. Corco paid for the shares by issuing a $600,000 demand promissory note.

[34] BPL then redeemed those shares from Corco in exchange for $600,000 and Corco used the money to pay the demand promissory note.

[35] The Appellant testified that she did not know how Mr. McAllister planned to finance the share purchase. Mr. McAllister testified that he did not talk to the Appellant about the loan. I found the Appellant and Mr. McAllister to both be credible. However, on this point, I think that a more accurate description would be that, when the transactions occurred, the Appellant was aware that there were additional steps that had to be undertaken, that someone was going to have to borrow money and that there was going to be a share redemption but, as none of these things affected her, she did not pay particular attention to the details.

[36] I should note that Wallace Brown did not testify. Neither party asked me to draw an adverse inference from his failure to do so and I have not. As the controlling shareholder of BPL and a party to the Unanimous Shareholder Agreement, Wallace Brown clearly had a significant ability to direct how the transactions occurred. However, I accept the Appellant's and Mr. McAllister's testimony that Wallace Brown stayed out of the negotiations and simply did what was required of him to close the transactions. In the absence of any evidence from him, I have not considered his motivations for doing so.

G. Tax Reporting and Reassessment

[37] The Appellant reported a capital gain of $599,960. The redemption of the shares in BPL held by Corco resulted in a deemed dividend. Corco claimed a deduction under section 112 resulting in no tax liability.

[38] The Minister of National Revenue reassessed the Appellant under section 84.1 to remove the capital gain from her income and replace it with a deemed dividend.

H. The Future

[39] BPL repaid the loan within two or three years.

[40] The company continued to grow. In 2021, Mr. McAllister bought Wallace Brown's Class A voting preferred shares and common shares for $1,000,000 leaving him and Corco with 100% of the future growth of the company.[1] Wallace Brown continued to own his Class B preferred freeze shares.

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[1] Mr. McAllister testified that he bought Mr. Brown's shares. It was unclear whether he personally purchased them or whether he meant that Corco purchased them. As nothing turns on this, I will take his testimony at face value and accept that he purchased them.

III. **Application of Section 84.1**

A. Tests to Be Met

[41] Section 84.1 is an anti-avoidance rule designed to prevent surplus stripping. A number of conditions have to be satisfied for the section to apply. Most of those conditions are not in issue.

[42] The parties agree that section 84.1 will only apply to the transactions in question if:

(a) the Appellant and Corco did not deal at arm's length when Corco purchased the Appellant's shares; and

(b) immediately after the sale of the Appellant's shares, Corco and BPL were connected within the meaning of section 186(4).

[43] I find that neither of these tests was met.

B. Appellant and Corco Dealt at Arm's Length

[44] The parties agree that the Appellant and Corco are not related persons within the meaning of subsection 251(2) and therefore that the only way that they could be considered to be non-arm's length was if they were determined to be factually non-arm's length in accordance with paragraph 251(1)(*c*).

[45] The case law establishes that parties can be found to be non-arm's length under paragraph 251(1)(*c*) if the parties act in concert without separate interests.[2] The Respondent submits that the Appellant and Corco met that test. The Respondent says Corco was a facilitator whose sole role was to allow the Appellant to make use of her capital gains deduction. I disagree.

[46] The Respondent's theory is based on the mistaken premise that the Appellant wanted out of BPL and Mr. McAllister and Corco agreed to help her to do that in the most tax efficient way possible. That is not at all what happened.

[47] Mr. McAllister approached the Appellant. He was the one who wanted her out of the company. She had not considered selling her shares.

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2 *McNichol v. The Queen*, 97 DTC 111 (TCC).

[48] The Appellant and Corco engaged in hard bargaining regarding the terms of the sale. The Appellant was willing to sell, but only and the right price and only if she could use her capital gains exemption.

[49] I find that the transactions were structured in the way they were to benefit Corco. Corco needed a way to finance the purchase. Mr. McAllister had neither the available funds nor the ability to borrow them. He needed BPL to finance the buyout and wanted the interest to be deductible by BPL. Mr. McAllister and Corco personally guaranteed the loan because they, not Wallace Brown, were the ones who stood to benefit from it.

[50] By contrast, the Appellant did not care how or whether Corco arranged financing, so long as she was paid in full on closing. The Appellant benefited from the fact that she received capital gains treatment but she would also have achieved that result if Mr. McAllister bought her shares. Furthermore, she would have achieved that result whether the purchaser bought her shares with the purchaser's own money or using borrowed money.

[51] The transactions were simply a step in Mr. McAllister's long-term plan to own BPL, a plan that started in 2007 when he approached Wallace Brown about buying shares in BPL, continued in 2015 when changing circumstances gave him the opportunity to remove the Appellant as a shareholder, and moved closer to complete fruition in 2021 when he and Corco became BPL's only common shareholders.

[52] The Respondent submits that the Appellant, Corco, Wallace Brown and BPL were ultimately in no different position than they would have been if BPL had borrowed money and used it to redeem the Appellant's shares. This is not a fair comparison. The Respondent is asking me to compare what actually happened to a set of transactions that never would have happened.

[53] The parties only ended up in the position that they did because the Appellant, when asked, was willing to sell her shares to Corco. If she had been unwilling, the evidence indicates that no transactions would have occurred. There was no evidence that BPL had any right to redeem or purchase the Appellant's shares. BPL's Unanimous Shareholders Agreement did not contain a shotgun clause. Even if the Appellant had resigned her employment with BPL (which she did not intend to do), the Unanimous Shareholders Agreement only provided a mechanism by which Wallace Brown and Mr. McAllister (not BPL) could buy her out.

[54] The Respondent also argues that Corco did not benefit from the transactions. Again, this argument is based on the false premise that the transactions would otherwise have occurred through a redemption of the Appellant's shares. Corco clearly benefited from the transactions. It significantly increased its share of BPL's future growth from 40% to 66.7%, an increase that would not have happened without the sale and that, given what Mr. McAllister paid Wallace Brown for his shares in 2021, appears to have been very lucrative for Corco. In addition, Corco indirectly benefited from the additional cashflow that became available to BPL once it no longer had to pay the Appellant a salary.

[55] The parties directed me to the following cases: *Brouillette v. The Queen*,[3] *McMullen v. The Queen*,[4] *Poulin v. The Queen*,[5] and *RMM Canadian Enterprises Inc. v. The Queen*.[6] I find that the Appellant's circumstances are far more similar to those where section 84.1 was found not to apply (*Brouillette*, *McMullen* and Mr. Poulin's circumstances in *Poulin*) than they were to those in *RMM* where section 212.1 was found to apply or to those of Mr. Turgeon in *Poulin* where section 84.1 was found to apply.

[56] Ultimately, for the Appellant and Corco to have been acting in concert without separate interests, there must be something more than sharing the same tax advisors and having a common interest in getting the deal done.[7] Based on the evidence before me, I cannot see what that something more was.

C. Corco and BPL Were Not Connected

[57] Having concluded that the Appellant and Corco dealt at arm's length, there is no need for me to consider whether Corco and BPL were connected within the meaning of subsection 186(4). I will nonetheless briefly address the issue.

[58] The parties agree that Corco and BPL were not connected under paragraph 186(4)(*b*). At first glance, they would appear not to have been connected under paragraph 186(4)(*a*) either because BPL was not controlled by Corco. However, subsection 186(7) causes subsection 186(2) to apply. Subsection 186(2) would deem BPL to have been controlled by Corco if more than 50% of BPL's

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3 2005 TCC 203.
4 2007 TCC 16.
5 2016 TCC 154.
6 97 DTC 302 (TCC).
7 *Brouillette*; *McNichol*; *McMullen*; and *Poulin*.

shares having full voting rights belonged to a person with whom Corco did not deal at arm's length.

[59] Since, immediately following the sale of the Appellant's shares, Wallace Brown owned in excess of 90% of BPL's voting shares, subsection 186(2) could only deem Corco to control BPL if Wallace Brown dealt at non-arm's length with Corco. Nothing in the evidence would support that conclusion. On the contrary, everything indicates that Wallace Brown at all times dealt at arm's length with Corco.

IV. **Conclusion**

[60] Based on all of the foregoing, the reassessment of the Appellant's 2015 tax year is vacated.

V. **Alternative Minimum Tax**

[61] The appeals of the Appellant's 2016, 2017 and 2018 tax years relate to alternative minimum tax carryovers that arose as a result of the Appellant's capital gain in 2015. The parties agree that the result in the appeals of the 2016, 2017 and 2018 taxation years should be the same as the result in the appeal of the 2015 tax year. Since I have vacated the reassessment of the 2015 tax year, I will accordingly vacate the reassessments of the 2016, 2017 and 2018 tax years.

Signed at Ottawa, Canada, this 16th day of May 2024.

"David E. Graham"

Graham J.

CITATION:	2024 TCC 71
COURT FILE NO.:	2022-3096(IT)G
STYLE OF CAUSE:	KATHRYN J CARTER v. HIS MAJESTY THE KING
PLACE OF HEARING:	Fredericton, New Brunswick
DATE OF HEARING:	April 30 and May 1, 2024
REASONS FOR JUDGMENT BY:	The Honourable Justice David E. Graham
DATE OF JUDGMENT:	May 16, 2024

APPEARANCES:

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