COMMENT

Neuman v. M.N.R.: The Supreme Court Allows Income Splitting

SANDRA E. JACK*

I. INTRODUCTION

SUBSECTION 56(2) OF THE *Income Tax Act*[1] is an anti-avoidance provision designed to prevent taxpayers from avoiding tax by diverting income to another person. Subsection 56(2) partially provides as follows:

> 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 extent that it would be if the payment or transfer had been made to the taxpayer.[2]

The Supreme Court of Canada's decision in *Neuman* v. *M.N.R.*[3] has provided clarity to the application of subsection 56(2) and made broader comments regarding income splitting in general.

II. THE FACTS

MR. MELVILLE NEUMAN, the appellant taxpayer, was a partner in a Winnipeg law firm. He and his partners owned the shares of Newmac Services (1973) Ltd. ("Newmac") which owned commercial property in downtown Winnipeg, in-

---

* C.A., LL.B. (Calgary). Ms. Jack is a partner with the firm of Felesky Flynn, Calgary, Alberta.

1 R.S.C. 1985 (5th Supp.), c.1 [hereinafter the *Act*]

2 The wording of subsection 56(2) in 1982 was substantially the same.

3 [1998] 1 S.C.R. 770 [hereinafter *Neuman*]

cluding the offices of the law firm, and provided services to the law firm pursuant to a management contract.

Melru Ventures Inc. ("Melru") was incorporated by Mr. Neuman on 29 April 1981 as a family holding company. The authorised capital of Melru included several different classes of shares. Dividends were to be declared at the sole discretion of the directors and distributions of dividends could be made selectively among the classes of shares.

Two classes of shares were particularly relevant to the appeal. The voting Class G shares were entitled to non-cumulative discretionary dividends at a rate not exceeding "the equivalent of 1 percent per annum on 'redemption price' above the maximum prime bank rates."

The dividend rights of the non-voting Class F shares provided:

> [A]ll 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 1cents per share on the Class "F" share 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 cents 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.

On 29 April 1981, Mr. Neuman transferred his shares in Newmac to Melru for voting Class G shares of Melru having a stated fair market value of $120 000. A subsection 85(1) election was filed by Melru and Mr. Neuman providing for a tax-deferred transfer. The value of $120 000 was never challenged by Revenue Canada.

On 1 May 1981, the following occurred in the order set forth: A meeting of the first director (Mr. Neuman) of Melru was held at which Mr. Neuman was appointed president and his wife, Mrs. Ruby Neuman, was appointed secretary. One voting common share of Melru was issued to Mr. Neuman for $1; a special general meeting of the shareholders was held at which Mr. Neuman resigned as first director and was elected as the director of Melru until the first annual meeting. Mrs. Neuman acted as secretary; a meeting of the board of directors was held at which Mr. Neuman was the Chairman. Resolutions were passed authorising the issuance of Class G shares to Mr. Neuman for the shares of Newmac and 99 non-voting Class F shares to Mrs. Neuman for $99.

On 12 August 1982 the first annual meeting of shareholders was held. Mrs. Neuman was elected as sole director of Melru by Mr. Neuman who held all the voting shares. Mr. Neuman and Mrs. Neuman were appointed as officers. In 1982 Melru received dividends of $20 000 on the Newmac shares.

On 8 September 1982, at a board of directors meeting of Melru, Mrs. Neuman, as sole director, declared dividends of $5 000 on the Class G shares held

by Mr. Neuman and $14 800 on the Class F shares held by her. The minutes indicate that Mr. Neuman, the holder of the common share, was prepared to have money set aside for future payment on that share.

Mrs. Neuman immediately loaned $14 800 to her husband and received a demand non-interest bearing promissory note. Mrs. Neuman died in 1988. The loan was not repaid.

At the hearing before the Federal Court Trial Division,[4] the Court made the following findings of fact. Melru was incorporated for tax planning and income splitting purposes and it had no other independent business purpose. The dividends declared by Mrs. Neuman on her own Class F shares and her husband's Class G shares were declared pursuant to a discretionary dividend clause in the Articles of Incorporation of Melru. The amount declared on each class was arbitrary. And third, Mrs. Neuman made no contribution to Melru,[5] nor did she assume any risks for the company.

Mr. Neuman's evidence was that when his wife was elected director of Melru, he explained to her the duties of a director, that directors manage the corporation, that they have a duty to the corporation, and that they make the decisions. Mr. Neuman said that he made recommendations to his wife which she accepted but that the decision as to the declaration of dividends was hers.

III. The Issue

The Minister of National Revenue reassessed Mr. Neuman's 1982 taxation year by including in his income the $14 800 dividend received by his wife. The Minister asserted that the dividend was a payment or transfer of property made to Mrs. Neuman pursuant to the direction of, or with the concurrence of, Mr. Neuman as described in subsection 56(2).

The issue was:

> whether dividend income, paid by a closely held family corporation to a non-arm's length shareholder who has not contributed to or participated in the business of the corporation, in this case Ruby Neuman, should be attributed to the shareholder's spouse, the appellant Melville Neuman, for income tax purposes in accordance with s. 56(2) of the *Income Tax Act*.[6]

---

[4] [1994] 1 C.T.C. 354.

[5] Other than the $99 paid for the Class F shares.

[6] *Supra* note 3 at para. 1.

IV. BACKGROUND

A. Income Splitting

The arrangement in *Neuman* was a classic income splitting or dividend sprinkling transaction. The purpose of these arrangements is to enable family members with low income to earn additional income which will be subject to lower tax rates than if such income was earned by another higher income family member. Successful income splitting among family members, therefore, creates more wealth for the family unit since less income tax is paid to the government.

Income splitting arrangements are most frequently established at the time of an estate freeze. An estate freeze freezes or caps the current value of particular property to enable future value to accrue to other individuals. In the *Neuman* circumstances, Mr. Neuman transferred the Newmac shares to Melru for fixed value Class G shares. He exchanged Newmac shares for Melru Class G shares at a time when the Newmac shares given up had a freeze value of $120 000. The Class G shares received had a fixed value of $120 000 since those shares were redeemable by Melru and retractable by Mr. Neuman for $120 000. Future growth in the value of Newmac would accrue to the 99 Melru Class F shares held by Mrs. Neuman and the 1 common share held by Mr. Neuman.

The response from the Department of Finance and Revenue Canada to ever increasing and creative income splitting schemes implemented by taxpayers has been ever increasing and complex legislation. Subsection 56(2) is one provision Revenue Canada has attempted to utilise to collect more tax. In addition, the various income attribution rules may apply where income earned by one person is deemed to be that of another or income is imputed to a person.[7] Many of these very detailed attribution rules, however, were enacted after 1982 such that they did not apply in *Neuman*. Finally, the general anti-avoidance rule[8] could apply to abusive transactions, however, this rule was not in effect in 1982.

B. The Queen v. McClurg

In 1990, the Supreme Court of Canada rendered its judgment in *McClurg* v. *Canada*,[9] in which the Minister attempted to apply subsection 56(2) to a taxpayer in respect of dividends received by his wife. The headnote for the case adequately sets forth the relevant facts:

> The respondent was one of the two directors of a corporation that operated a truck dealership. The corporation was established under the *Business Corporations Act* of Saskatchewan ("SBCA") with three classes of shares: Class A common, voting and

---

7 See *e.g.*, s. 74.4 of the Act.

8 *Income Tax* Act, s. 245, [hereinafter GAAR].

9 [1990] 3 S.C.R. 1020; [1991] 1 C.T.C. 169 [hereinafter McClurg cited to C.T.C.]

> participating, with the distinction and right to receive dividends exclusive of the other classes; Class B common, non-voting and participating when authorized by unanimous consent of the directors and with the distinction and right to receive dividends exclusive of the other classes; and Class C preferred, non-voting with the distinction and right to receive dividends exclusive of the other classes if authorized by unanimous resolution of the directors. All the 800 Class A shares and all the Class C shares were held equally by the respondent and the other director, Mr. Ellis. All the 200 Class B shares were held equally by their wives. In 1978, 1979 and 1980, the directors declared dividends and allocated them to the Class B shares only in the amount of $100 per share in each year for a total of $30 000 to each such shareholder. These dividends were the subject of the appealed assessments. The Minister assessed on the basis that the dividends should have been allocated equally to all the common shareholders, which would have given the appellant and Mr. Ellis 40 per cent each of the total distributed, i.e., $24 000. The Minister maintained that the discretionary dividend clause in the articles of association was contrary to the common law rule of equality of treatment of shareholders of a class. It also, he claimed, violated paragraph 24(4)(b) of the SBCA. If allocation among all the common shareholders had been made, the Class A holders would have received $24 000 each and the Minister assessed the respondent as one of them under subsection 56(2) of the *Income Tax Act* (ITA) as having been made to his wife with his concurrence as a director.[10]

McClurg, therefore, raised two basic issues, one of corporate law[11] and one of income tax law. The majority upheld both issues in favour of the taxpayer.

Although Chief Justice Dickson, writing for the majority, found that subsection 56(2) does not generally apply to a dividend payment, he went on to comment on the commercial reality of the particular transaction. He stated,

> [i]f a distinction is to be drawn in the application of s. 56(2) between arm's length and non arm's length transactions, it should be made between the exercise of a discretionary power to distribute dividends when the non-arm's length shareholder has made no contribution to the company (in which case s. 56(2) may be applicable), and those cases in which a legitimate contribution has been made.[12]

In other words, Dickson C.J.C. appeared to be suggesting that a taxpayer who is not dealing at arm's length with a shareholder who receives a dividend, could be reassessed under subsection 56(2) if the shareholder does not make a real or legitimate contribution to the corporation and the taxpayer directed, or concurred with, the dividend payment. These comments had no impact on Mrs. McClurg since it was found that she made a real contribution to the company by, *inter alia*, providing her services. Therefore, the comments were *obiter dicta*. This issue—whether a real contribution was required to avoid subsection 56(2)—was the critical issue in *Neuman*, since it was really the only distinguishing fact from *McClurg*.

---

10 *McClurg*, *supra* note 9 at 169.

11 The corporate law issue was whether the payment of dividends on the Class B to the exclusion of the Class A and Class C was *ultra vires* the corporation.

12 *McClurg*, *supra* note 9 at 185.

V. JUDICIAL HISTORY

IN BOTH THE TAX COURT OF CANADA and the Federal Court Trial Division, the Melru dividend was found not to be taxable to Mr. Neuman pursuant to subsection 56(2) despite the fact that the sole purpose of the income splitting arrangement was to obtain a tax advantage.[13] These Courts were inclined to the view that shareholder contributions to a corporation were irrelevant in dealing with the entitlement to and appropriateness of dividends, notwithstanding the comments of Chief Justice Dickson in *McClurg*.

The Federal Court of Appeal, however, held unanimously that the $14 800 Melru dividend paid to Mrs. Neuman was taxable to Mr. Neuman pursuant to subsection 56(2).[14] The Court adopted the *obiter dicta* comments of Chief Justice Dickson and found that subsection 56(2) technically applied. The Federal Court of Appeal held that the general rule established in *McClurg* (that dividends are not subject to attribution under subsection 56(2)) did not apply to dividends paid to a non arm's length shareholder who made no contribution to the corporation.

A. The Subsection 56(2) Conditions

Previous jurisprudence has established that subsection 56(2) only applies where four conditions are met:

(i) there is a payment or transfer of property to a person other than the reassessed taxpayer;

(ii) the reassessed taxpayer directs or concurs in the payment or transfer;

(iii) the payment or transfer is for the reassessed taxpayer's benefit or for the benefit of some other person on whom the reassessed taxpayer wished to have the benefit conferred; and

(iv) the payment or transfer would have been included in computing the reassessed taxpayer's income if it had been made to him instead of the other person.

In addition, counsel for Mr. Neuman argued that there is a fifth condition which qualifies the fourth condition as follows: *The fourth condition is not met where the reassessed taxpayer has no entitlement to the payment or transfer of property.*

---

[13] *Neuman* v. *M.N.R.* [1992] 2 C.T.C. 2075 (T.C.C.); [1994] 1 C.T.C. 354 (F.C.T.D.).

[14] [1996] 3 C.T.C. 270.

VI. THE SUPREME COURT DECISION AND FUTURE IMPLICATIONS

THE ANALYSIS OF THE Supreme Court of Canada in *Neuman* is refreshingly concise. In a unanimous decision delivered by Mr. Justice Iacobucci it was held that subsection 56(2) does *not* apply to dividend sprinkling. The sole reason given for this conclusion is that dividend sprinkling does not satisfy the fourth condition to the application of subsection 56(2) because, in the absence of the dividend payment, the dividend would remain part of the corporation's retained earnings and would not be included in the reassessed taxpayer's income.

The Court expressly held that the suggestion in *McClurg* that dividend receipts should be contingent upon the level of contribution by the recipient shareholder was incorrect. Iacobucci J. adopted La Forest J.'s dissenting views in *McClurg*:

> 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 ... 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.[15]

Based on this conclusion, it was not necessary for the Supreme Court to consider the issue whether Mr. Neuman directed or concurred in the payment of the dividend to Mrs. Neuman.

Therefore, the uncertainty created by the *obiter dicta* in *McClurg* has been removed. However, Iacobucci J. cautioned that subsection 56(2) *could* apply where the taxpayer had a pre-existing entitlement to the dividend income paid to the shareholder. Although not referred to in the written reasons, the Court appears to have been referring to the Appellant's argument regarding the fifth condition.

In *M.N.R.* v. *Bronfman*,[16] the Court applied the predecessor of subsection 56(2) to a circumstance where a corporation made gifts to non-shareholders. This provision was applied to include the gifts in the income of those shareholders who had the prospective entitlement to the distributions because the recipient non-shareholders had no such prospective entitlement.

Counsel for Mr. Neuman argued that the *Bronfman* case was distinguishable, since the freeze value of $120 000 was not challenged. Mrs. Neuman's investment in the Class F shares provided her with a *bona fide* entitlement to receive the dividend, rather than an entitlement of Mr. Neuman. This argument was accepted by the Supreme Court of Canada as evidenced by their caution that, in other cases, a pre-existing entitlement could result in the application of subsection 56(2).

---

[15] *McClurg*, *supra* note 9 at 195.

1965] C.T.C. 378 (Ex. Ct.) [hereinafter *Bronfman*]

This finding is very important for estate planning arrangements. It indicates that, provided the freeze value is accurate, a family member may acquire shares for a relatively nominal amount and become entitled to dividends from future growth and value in the corporation. In other words, this relatively nominal subscription amount for the growth shares produces a legitimate shareholder relationship which does not violate principles of commercial reality.

This may not be the case where the freeze is undertaken at a time when, for example, the chosen freeze value was too low, the freeze shares had inadequate value, or dividends had been declared but not yet paid at the time of the initial transfer to the family holding company. This may also be an issue where an appropriate freeze value is chosen but dividends are immediately paid which reduces the value of the freeze shares below the freeze value.[17] In *Neuman* these matters were not issues.

Also of particular interest in *Neuman* are the supportive comments of Iacobucci J. with respect to income splitting. The Court stated that there is no general scheme to prevent income splitting in the Act[18] and that "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... . The [Act] 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 [i.e., subsection 56(2)] when it is open for the legislator to be precise and specific with respect to any mischief to be avoided."[19]

This statement is somewhat tempered by certain observations made by Iacobucci J. at the beginning of his analysis, which observations were intended to put his analysis in its proper perspective. First, he notes that in 1982 the Act did not contain section 74.4 designed specifically to combat inappropriate income splitting.[20] Mr. Neuman would have been required to include an amount in income in respect of his Class G shares if section 74.4 had been applicable in 1982.

Second, the Court points out that the GAAR in section 245 also was not applicable in 1982 and, therefore, had no relevance in *Neuman*.[21] As a result, there is

---

[17] Such a dividend would be contrary to properly drafted share terms in the articles.

[18] *Neuman*, *supra* note 3 at para. 35.

[19] *Ibid.* at para. 63, relying on *Stubart Investments Ltd.* v. *The Queen*, [1984] 1 S.C.R. 536.

[20] *Ibid.* at para. 36.

[21] *Neuman*, *supra* note 3 at para. 37. Three income tax GAAR cases have been decided so far: *McNichol* v. *The Queen*, [1997] 2 C.T.C. 2088 (TCC); *Equilease Corporation* v. *The Queen*, [1998] 1 C.T.C. 2300 (TCC); and *Husky Oil Ltd.* v. *The Queen*, 97–1060(IT), unreported (TCC). In the first two cases the taxpayers lost; the taxpayer was successful in the third.

a question whether the GAAR can apply to an income splitting arrangement which otherwise satisfies all of the specific anti-avoidance rules, including section 74.4.

The GAAR is an anti-avoidance provision which, if applicable, will deny a tax benefit associated with an anti-avoidance transaction. However, pursuant to subsection 245(4), the GAAR will not apply to a transaction if it would not result directly or indirectly in a misuse of a provision of the Act or an abuse of the provisions of the Act read as a whole.[22] A tax benefit is defined to mean a reduction, avoidance, or deferral of tax, or an increase in a tax refund, under the Act. An avoidance transaction is defined to mean any transaction (including an arrangement or event) or series of transactions resulting directly or indirectly in a tax benefit, other than a transaction or series of transactions arranged primarily for *bona fide* non-tax purposes.

Based on the comments in *Neuman* to the effect that there is no general scheme to prevent income splitting and it is open to Parliament to enact specific anti-avoidance provisions to regulate income splitting, a strong argument can be made that if the many specific anti-avoidance rules do not apply to deny a favourable tax treatment, there is no misuse or abuse of the Act so the GAAR would not apply. The contrary argument, of course, is that the GAAR should be applied where the taxpayer manages to avoid the specific anti-avoidance rules by implementing an arrangement not anticipated by the government.

At the October 1998 Annual Conference of the Canadian Tax Foundation, Revenue Canada stated that the GAAR does not apply to a situation like *Neuman*, but may apply to other income splitting arrangements.[23] This is comforting to a degree, however, it remains uncertain what situations are like *Neuman*. At the same forum, the Department of Finance indicated it was reviewing the impact of *Neuman* but had not yet decided whether legislative changes are required.[24]

VII. SUMMARY

IN SUMMARY, three important principles can be derived from *Neuman*. First, there is no general scheme in the Act to prevent income splitting—taxpayers are entitled to arrange their affairs for the sole purpose of achieving a favourable tax result, subject however, to specific provisions of the Act, including the GAAR. Secondly, subsection 56(2) will not apply to dividends unless the reassessed taxpayer has a pre-existing entitlement to the dividend income paid to

---

22 Subsection 245(4).

23 Canadian Tax Foundation, *Canadian Tax Highlights: Special Report* (17 November 1998) at 1.

24 *Ibid.*

the shareholder. Finally, if the chosen freeze value in an estate freeze is accurate, there should be no pre-existing entitlement in the hands of the taxpayer subject to the freeze.