TAX FOR THE Owner-Manager

Editor: Thomas E. McDonnell, QC

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Jencal Holdings: The Application of Subsection 256(2.1)

Jencal Holdings Ltd. v. The Queen (2019 TCC 16) concerned the application of subsection 256(2.1), an anti-avoidance provision that deems two or more corporations to be associated if it may reasonably be considered that one of the main reasons for the separate existence of the corporations is to reduce the amount of taxes that would otherwise be payable under the Act.

The case arose out of a 2007 reorganization of a corporate group centred on the Foord family and the Kal Tire Partnership ("the KT partnership"), which carried on a global tire business. Tom Foord, the founder, originally controlled Kal Tire Holdings Ltd. ("KT Holdings"), which owned Kal Tire Ltd.; in turn, Kal Tire Ltd. held an interest in the KT partnership through a class of voting preferred shares. A family trust (whose beneficiaries were the founder's five adult children) held common shares of KT Holdings. The small business deduction (SBD) could not be claimed by Kal Tire and KT Holdings because the taxable capital of the associated group exceeded the relevant limit.

The 2007 reorganization resulted in the distribution of the common shares of KT Holdings to the children. Each child's shares in KT Holdings were transferred to a new Holdco. Jencal (the appellant) was created for one of the children, Jean Finch. She held voting control "estate freeze" preferred shares of Jencal, and a family trust held the common shares. A similar structure was set up for three other Holdcos; the shares of the remaining Holdco were held by the fourth child.

The 2007 reorganization also involved a series of transactions involving Kal Tire Ltd., KT Holdings, the Holdcos, and the KT partnership that included dividends and loans. Each Holdco could earn $500,000 of interest income in a year from KT Holdings.

KT Holdings elected under subsection 256(2) (as it read during the relevant taxation years) not to be associated with each Holdco for the purposes of section 125. However, KT Holdings and each Holdco were associated for the purposes of paragraph 129(6)(b). Thus, the interest income received by the Holdcos from KT Holdings was deemed to be ABI, and Jencal and the other Holdcos could claim a separate SBD in respect of the interest income.

The minister reassessed Jencal's 2012, 2013, and 2014 taxation years and denied its SBD on the basis of subsection 256(2.1). The question was the applicability of the subsection—namely, whether one of the main reasons for Jencal's separate existence in each year was the reduction of tax. The burden was on Jencal to show that reducing tax was not one of the main reasons for its separate existence.

The TCC concluded that in the absence of any direct testimony, there was insufficient evidence to prove Jencal's position. It found that the best evidence for the reasons for the separate existence of Jencal was documentary. The documents included a 1998 KPMG plan designed to address the 21-year deemed disposition rule relating to the original family trust, and a 2000 KPMG letter that introduced the possibility of using holding corporations to freeze the interests of the founder's children. The documents also included a January 2002 KPMG instruction letter to a law firm to implement a plan ("the 2002 plan") that specifically highlighted the use of separate holding companies for the purposes of tax minimization, and a 2004 KPMG memo that referred explicitly to the multiplication of the SBD. The 2007 reorganization was completed substantially in conformity with the 2002 plan as set out in the 2004 KPMG memo.

On the basis of the documentary evidence, the TCC found that in the five years leading up to the incorporation of Jencal, Jean Finch was made aware at least twice of the tax advantages of using a separate holding corporation. Jencal cited a number of non-tax reasons for the establishment of separate holding corporations: estate planning, keeping ownership in the family, corporate and partnership governance, and investment planning. The TCC found that estate planning was likely a non-tax reason for the separate existence of the Holdcos generally, but not specifically for the existence of Jencal; it rejected the other three explanations. The court then held that Jencal had failed to show that none of the main reasons for its separate existence was the reduction of tax. Therefore, the appeal was dismissed and subsection 256(2.1) was applied to

associate KT Holdings and Jencal for the relevant taxation years. It was not necessary for the court to consider GAAR in light of this conclusion.

Although legislative changes subsequent to *Jencal Holdings* have significantly curtailed planning designed to multiply the SBD, the case serves as an important reminder to tax practitioners of how anti-avoidance tests employing purpose standards can run afoul of otherwise technically effective planning. Practitioners should keep in mind that an adverse party will review purported explanations of purpose, and they should therefore give careful consideration to the relative strength of the arguments.

Philip Friedlan and Adam Friedlan
Friedlan Law
Richmond Hill, ON