T A X FOR THE Owner-Manager

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The Active Asset Management Case and the Treatment of Deemed and Declared Dividends Under Section 160: When Does the Issuance of a Demand Promissory Note Constitute Payment?

This article examines the recent decision in *Active Asset Management Inc. v. The King* (2024 TCC 87), in which the Tax Court examined whether certain deemed dividends under subsection 84(1) of the ITA and certain declared dividends (in respect of which promissory notes were issued but remained outstanding) constituted transfers of property that gave rise to liability under section 160 of the ITA. The case is noteworthy both for the narrow technical question it addresses and for certain concerns regarding the broader question of when the issuance of a demand promissory note constitutes payment for tax purposes.

The facts in this case are relatively straightforward. The appellant, Active Asset Management Inc. ("AAM"), was a shareholder of Bakorp Inc. ("Bakorp"), which, as of December 31, 2004, owed significant amounts of taxes and penalties. On December 1, 2004, pursuant to shareholder resolutions, AAM significantly increased the legal stated capital in respect of both its class A shares and its class B shares. These increases resulted in deemed dividends to AAM by virtue of subsection 84(1) of the ITA ("the deemed dividends"). Under subsection 84(1), when a corporation increases the paid-up capital of a class of shares, the corporation is deemed to have paid a dividend to the holders of the shares of that class of shares, and those shareholders are deemed to have received a dividend from the corporation.

In addition, by a director's resolution (also dated December 31, 2004), Bakorp declared significant dividends ("the declared dividends") on both its class A shares and its class B shares. Bakorp issued to AAM promissory notes, due on demand ("the demand notes"), in respect of the declared dividends. Bakorp never paid, nor had AAM ever demanded, payment in respect of the demand notes.

On April 5, 2018, AAM was assessed pursuant to subsection 160(1) in respect of "a transfer on or about December 31, 2004 from [Bakorp] to [AAM] of assets in the form of dividends" in the amount of $20,304,746. This amount was reduced to $11,983,407 as a result of AAM's objection to the underlying assessment that gave rise to the subsection 160(1) liability.

The TCC ultimately held that neither the deemed dividends nor the declared dividends were "transfers of property" within the meaning of subsection 160(1) of the ITA. In reaching these conclusions, Bocock J set out the four requirements that must be met in order to engage subsection 160(1) so that a transferor's outstanding tax liability is imposed on a transferee. Those requirements are as follows: (1) the transferor must be liable to pay a tax under the ITA at the time of transfer; (2) there must be a transfer of property; (3) the transfer must be to a person with whom the transferor was not dealing at arm's length or to an otherwise designated transferee; and (4) the fair market value of the property transferred must exceed the fair market value of the consideration given by the transferee for the property.

The only issue in dispute in this case was the requirement that there be a transfer of property by the transferor to the transferee. We note that, with respect to requirements 1, 3, and 4, subsequent legislative amendments (in particular, the introduction of subsection 160(5)) have significantly broadened the circumstances in which these requirements will be met.

The TCC held that, in order for there to be a transfer of property within the meaning of subsection 160(1), there had to be an enrichment conferred on the recipient and "a concordant impoverishment settled upon the grantor."

With respect to the deemed dividends, Bocock J held that no impoverishment had occurred. In support of this conclusion, the TCC stated that Bakorp paid no funds in respect of the deemed dividends and did not incur any liability. In the court's view, all that Bakorp did was take its recorded retained earnings and recharacterize them as "appreciated stated capital" to the shareholder of record. The result of this recharacterization was that AAM held the same shares as previously but with a different legal stated capital account balance. In the court's view, this meant that AAM had received "not a penny."

The TCC then held that the mischief targeted by section 160 (namely, the avoidance of the payment of a tax debt) had not occurred because the effect of the deemed dividends was not to deplete the assets of Bakorp in any way. On that basis, the court held that the deemed dividends did not give rise to a transfer of property capable of attracting the application of section 160.

With respect to the declared dividends, Bocock J held that the demand notes were merely evidence of debt and that no payment of cash or transfer of assets in kind (securities, bonds, or even shares) had occurred and, therefore, no enrichment of AAM. The TCC noted that subsequent payment of the notes would denote transfers within the meaning of section 160. The court also held that the demand notes were not payable until "demand is made" and, furthermore, that even if such a demand and presentment were made, "no transfer would occur until payment, in cash or in kind, actually occurs." The declared dividends were merely contingent liabilities. Accordingly, Bocock J held that section 160 could not apply to the declared dividends because no transfer of property had occurred.

This case is a welcome decision for taxpayers. However, Bocock J's holding that the issuance of a demand promissory note does not in and of itself constitute payment highlights the technical challenge, for tax practitioners, of ensuring that the issuance of a promissory note constitutes payment for legal purposes.

It is our understanding that, under the law of payment, the issuance of a promissory note is merely evidence of an obligation to pay and constitutes conditional payment only. However, it is also our understanding that where a promissory note is accepted as absolute payment, this is not conditional payment; the amount is considered paid (see Joan Jung, "Dividend Planning," in *2022 Ontario Tax Conference*, at 9-10; and Arnold et al., *Timing and Income Taxation*, 2d ed., at 374-78). We also note that in *Banner Pharmacaps NRO Ltd. v. Canada* (2003 FCA 367), the FCA may have adopted the view that whether a promissory note constitutes payment is determined by the intention of the "maker of the note" (that is, the payer). Accordingly, in order to ensure that amounts intended to be paid via the issuance of a promissory note constitute payment for legal purposes (rather than conditional payment), it is advisable that the recipient of the note provide written acceptance of the note as absolute payment, and that the terms of the note evidence the intention of the payer to issue the note in absolute payment of the dividend.

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