

# Tax Topics

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## TAX PLANNING FOR THE NON-SPECIALIST ADVISOR — NEW SUCCESSION PLANNING STRATEGY FOR THE OWNER-MANAGER: PART II

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Part I of this two-part series of articles (the "Series") contained a non-technical discussion of surplus stripping and the impact of section 84.1 of the *Income Tax Act* (the "Act")<sup>1</sup> on owner-manager succession involving non-arm's length<sup>2</sup> corporate purchasers (i.e., the Section 84.1 Penalty). In addition, Part I provided a review of the surprising legislative effort to alleviate the Section 84.1 Penalty in limited circumstances, including a high-level review of the technical requirements needed to ensure that, in those limited circumstances, the Section 84.1 Penalty would not be applicable. Part II of the Series will provide a practical example to illustrate both the Section 84.1 Penalty and how amended section 84.1 will alleviate the Section 84.1 Penalty in certain limited situations. Part II will also describe ongoing concerns and issues with relying on amended section 84.1.

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### Supporting Intergenerational Private Enterprise Succession — An Illustration of the Tax Impact of Eliminating the Section 84.1 Penalty

Owner-managers who are able to take advantage of amended section 84.1 to sell qualified small business corporation ("QSBC") shares or shares of family farm or fishing corporations (collectively, the "Qualifying Shares") to a non-arm's length purchaser corporation that meets certain conditions that will deem the purchaser corporation to act at arm's length with the vendor (collectively, the "Deemed Arm's Length Conditions", which are described in detail in Part I of the Series) may enjoy significant intergenerational tax savings.

As an example, Linda has successfully grown an incorporated bridal business, La Boutique Inc. ("LBI"), in Toronto, Ontario. She has always been the sole shareholder of LBI and she originally acquired her shares of the corporation by subscription for \$10 so that their adjusted cost base ("ACB") and paid-up capital ("PUC") are also \$10.

<sup>1</sup> R.S.C. 1985, c. 1 (5th Supp.), as amended. Unless otherwise noted all statutory references are to the Act.

In this article all tax rates are assumed to be the top 2022 marginal Ontario tax rate for an individual taxpayer.

<sup>2</sup> Determined in accordance with subsection 251(1).

An arm's length international conglomerate ("IC") recently offered Linda just over \$1,000,000 for all of the shares of LBI. As a result, Linda's professional advisors have told her that if she sold the shares of LBI she would realize a capital gain of, to keep the numbers simple, \$1,000,000.

The professional advisors have also advised Linda that:

- (1) the LBI shares are QSBC shares;
- (2) she has never before claimed any of her lifetime capital gains exemption ("CGE"); and
- (3) there are no impediments that would impact her ability to utilize her CGE.<sup>3</sup>

As a result, the professional advisors tell Linda that for tax purposes she could offset \$913,360 of the capital gains with her CGE and would only pay tax on \$86,640 of capital gains, resulting in a total tax liability to Linda of just over **\$23,000**.

Linda's granddaughter, Beth, had always dreamed of one day buying Linda's shares of LBI and keeping her grandmother's business within the family.

Beth has diligently worked to create her own successful incorporated floral business, Fleurs Inc. ("Fleurs"), and she feels that LBI's business would complement her floral business.

Beth is more than happy to buy LBI from Linda on exactly the same terms as IC — for \$1,000,000 cash.

Beth was advised to have Fleurs purchase Linda's shares of LBI so that the purchase price can be paid with active business income from Fleurs, which has been taxed in Fleurs at a lower rate than Beth would have to pay personally if she had to remove the cash from Fleurs.

Prior to the amendments to section 84.1, the acquisition would have been subject to the Section 84.1 Penalty.

As a result, it is assumed that section 84.1 would have given rise to a \$1,000,000 deemed dividend being received by Linda, resulting in Linda paying tax of **\$477,400**.

In the absence of the amendments to section 84.1, selling LBI to Fleurs would cost Linda over **\$450,000** more than a sale to IC. As a result, Linda had indicated to Beth that she would have had no choice but to sell LBI to IC.

However, thanks to the amendments to section 84.1, the sale of the LBI shares to Fleurs will not be subject to amended section 84.1, provided that Linda is able to comply with certain administrative requirements set out in the legislation, described in detail in Part I of the Series (the "Administrative Requirements"). This is because the LBI shares, being QSBC shares, will be Qualifying Shares and a sale of the LBI shares to Fleurs, which is owned by Linda's granddaughter, will meet the Deemed Arm's Length Conditions. Consequently, the amendments to section 84.1 will, in these circumstances, have eliminated the Section 84.1 Penalty, levelling the playing field between arm's length and non-arm's length purchasers of LBI, making it possible for LBI to remain a family business.

Unfortunately, the relief from the Section 84.1 Penalty is really quite narrow. For example, had Beth been a non-arm's length person other than a child or grandchild of Linda,<sup>4</sup> the amendments to section 84.1 would not have been sufficient to avoid the Section 84.1 Penalty.

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<sup>3</sup> She has never claimed an "allowable business investment loss" (see paragraph 39(1)(c), sometimes referred to as an "ABIL") and she does not have a "cumulative net investment loss" balance (see subsection 110.6(1), sometimes referred to as a "CNIL balance"). Also, she earns sufficient income so that "alternative minimum tax" (see section 127.5 and related provisions, sometimes referred to as "AMT") will not be applicable.

<sup>4</sup> Other non-arm's length persons that are not protected from the Section 84.1 Penalty would include:

- (1) All other persons who are "related" to the transferor (see paragraph 251(1)(a)). "Related persons" under the Act is a complex concept that includes persons with "blood relationships," including siblings, relations through marriage or common-law partnership, and adoption (subsection 251(6)), and certain corporations (subsection 251(2));
- (2) Relations with certain trusts (paragraph 251(1)(b)); and
- (3) Factually non-arm's length persons (paragraph 251(1)(c)).

In addition, a transfer from an individual to related persons of a more senior generation would not be eligible for relief from the Section 84.1 Penalty.

## Minister of Finance Has Issues With Bill C-208

As previously mentioned, Bill C-208's enactment proceeded without oversight or comments from the Minister of Finance ("MoF").

Consequently, the drafting of the amended provisions is far from precise,<sup>5</sup> and within weeks of its enactment the MoF confirmed its intention to seek to amend the legislation to address identified loopholes that it believes are contrary to the object, spirit, and purpose of the enacted changes.<sup>6</sup> The MoF provided a list of some of the issues that the amendments are intended to address in a news release on July 19, 2021 (see "Government of Canada clarifies taxation for intergenerational transfers of small business shares"), which include:

- (1) The requirement to transfer legal and factual control of the corporation carrying on the business from the parent to their child or grandchild;
- (2) The level of ownership in the corporation carrying on the business that the parent can maintain for a reasonable time after the transfer;
- (3) The requirements and timeline for the parent to transition their involvement in the business to the next generation; and
- (4) The level of involvement of the child or grandchild in the business after the transfer.

Although the MoF indicated that amendments were to be made by November 1, 2021, with effect from January 1, 2022, no announcement has been made to the present date.

As a result of the MoF warnings, a number of authors have warned taxpayers about relying on amended section 84.1, especially when the taxpayer's plans are not truly motivated by intergenerational Qualifying Share transfer considerations.<sup>7</sup>

## Relying on Amendments to Section 84.1

Notwithstanding the caveats noted above, the enactment of Bill C-208 has changed section 84.1. In appropriate intergenerational transfer situations, amended section 84.1 now offers owner-managers a tax-efficient intergenerational succession planning strategy to transfer Qualifying Shares that satisfy the Deemed Arm's Length Conditions and meet the Administrative Requirements.

As mentioned previously, unfortunately, not all succession planning will involve Qualifying Share transfers that are able to satisfy the Deemed Arm's Length Conditions. Thankfully, there are other succession planning strategies available for owner-managers (e.g., the use of an estate freeze, insurance strategies, etc.), so it is important for owner-managers to consult with qualified tax and other multi-disciplinary professionals to help determine the most effective approach to meet their own personal and broader family current and long-term tax and non-tax objectives.

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<sup>5</sup> Some of the "warts" have been written about and discussed. For example, see Nichols and Horning Wolters Kluwer Canada *Tax Topics*, "When Parliamentarians Tinker," July 6, 2021, no. 2574: 1–3; and Jennifer Reid and Danielle Wallace, "Intergenerational Transfers of Businesses and Bill C-208: Where We Are Now" 2021 *Canadian Tax Focus* 11(4): 1–2.

<sup>6</sup> Chrystia Freeland, Deputy Prime Minister and Minister of Finance, addressed the requirement for the amendments by saying that "...The law is the law. Our concern is with technical elements of the bill that could unintentionally present opportunities for tax avoidance. The amendments we intend to bring will honour the law passed by Parliament, make sure everyone pays their fair share, and support the families and small businesses that keep our economy, and our communities, strong."

<sup>7</sup> For example, see Mezzetta, "Will CRA challenge small biz transfers that use Bill C-208?" *Advisor's Edge*, July 27, 2021. For a more technical discussion see Nichols and Horning Wolters Kluwer Canada *Tax Topics*, "Deans Knight Intersects Bill C-208: The Meaning of Control and Implications for Intergenerational Transfers," August 31, 2021, no. 2582: 1–2. Tax planners might wish to also review *The Queen v. Alta Energy*, 2021 DTC 5125 (SCC) and *Canada v. Loblaw Financial Holdings Inc.*, 2021 DTC 5131 (SCC), both of which appear to take a more measured approach to the ability of taxpayers to plan their affairs than in the *Deans Knight* (2021 DTC 5095 (FCA)) decision referenced in the Nichols and Horning article.

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