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

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As tax lawyers, owner-managers often ask us to assist them with effectively transitioning the ownership of their business to one or more of their family members. Recent changes to Canada's *Income Tax Act* (the "Act")[1] have presented owner-managers with a new succession planning strategy that could make the decision as to whether owner-managers sell their incorporated businesses to an unrelated purchaser or to certain close family members tax neutral, which previously was often not the case due to the potential application of section 84.1 and the penalty it imposed on non-arm's length[2] transfers (the "Section 84.1 Penalty," as described more fully below).

Part I of this two-part series of articles (the "Series") contains a non-technical discussion of surplus stripping and the impact of section 84.1 on owner-manager succession involving non-arm's length corporate purchasers (i.e., the Section 84.1 Penalty). In addition, Part I reviews 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 will 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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Surplus Stripping and Section 84.1

The Canada Revenue Agency ("CRA") and the Minister of Finance ("MoF") often take the position that corporate distributions to individual taxpayers should be taxed as taxable dividends, at rates of up to 47.74%,[3] and not as capital gains, taxed at more favourable

[1] 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.

[2] Determined in accordance with subsection 251(1).

[3] See paragraph 84.1(1)(*b*). Under certain circumstances it may be possible to designate the deemed dividend to be taxed as an eligible dividend taxed at 39.34% or possibly even as a capital dividend, which would be tax-free to the dividend recipient (for example, see Hirji and Keung, "Planning Possibilities Resulting from CRA Policy Reversal on Section 84.1" 2020 Tax for the Owner-Manager 20(1): 8).

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rates of up to 26.76%; when eligible for the "capital gains deduction", which is sometimes referred to as the "capital gains exemption" ("CGE"), up to $913,360 of capital gains can potentially be earned during a person's lifetime tax-free.[4] Consequently, these government authorities often consider planning transactions that would otherwise achieve this result, often referred to as "surplus stripping transactions," as potentially abusive and have regularly sought to deny the benefits of such planning, being successful only sporadically.[5]

The CRA and the Department of Justice have not been successful in having the Canadian courts declare that there is a scheme in the Act that is intended to deny surplus stripping.[6] However, there is no question that the Act contains provisions, such as section 84.1, which are designed to counter particular non-arm's length surplus stripping strategies, by giving rise to deemed dividend treatment for taxpayers caught by this provision.[7]

Unfortunately, prior to the Bill C-208 amendments to the Act, section 84.1 would generally apply[8] whenever an owner-manager desired to sell their shares of a private corporation to another non-arm's length private corporation for proceeds that included non-share consideration (e.g., cash, promissory notes, etc.) in excess of the "hard" adjusted cost base ("ACB") of the transferred shares.[9]

Since section 84.1 is not applicable if the purchaser of an owner-manager's private corporation shares is a corporation that is arm's length with the owner-manager, an owner-manager has always been able to enjoy capital gains and/or CGE treatment on sales of shares to arm's length corporate purchasers. As a result, the Act (inadvertently?) created a situation that punished intergenerational succession planning of private corporations when the purchaser was a non-arm's length private corporation (the "Section 84.1 Penalty").

Enter Bill C-208

Bill C-208 was a private member's bill that was introduced to eliminate, among other things,[10] the Section 84.1 Penalty in situations where:

(1) an owner-manager's private corporation shares are, at the time of transfer, qualified small business corporation ("QSBC") shares or shares of family farm or fishing corporations[11] (collectively, the "Qualifying Shares");

(2) the purchaser corporation 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 below); and

(3) the owner-manager abides by certain administrative requirements (collectively, the "Administrative Requirements", which are described in detail below).

Attempts to change section 84.1 have been made in the past and always seemed to fail. And yet, somehow,[12] Bill C-208 made it through the legislative gauntlet without any substantial amendments or apparently oversight by the MoF and was enacted on June 29, 2021, warts and all.[13]

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[4] See section 110.6. The maximum amount of an individual's CGE has been indexed to inflation (subject to a maximum of $1,000,000 (subsection 110.6(2.2))). The value of the CGE to a top rate Ontario taxpayer in 2022 is nearly $245,000.

[5] For example, see *MacDonald v. R*, 2013 DTC 5091 (FCA).

[6] Much is written on this topic. Readers desiring details might wish to review Dishy and Anderson, "The Permissibility of Surplus Stripping: A Brief History and Recent Developments" 2021 Canadian Tax Journal 69(1): 1–33.

[7] Please note that paragraph 84.1(1)(*a*) can also result in a reduction in the paid-up capital ("PUC"), as that term is defined in subsection 89(1), of share consideration received by a taxpayer from a purchaser under certain situations, but this article will not focus on this element of section 84.1. (PUC can generally be returned to a taxpayer without giving rise to a deemed dividend (in some circumstances a return of PUC will give rise to capital gains) and is therefore a valuable tax attribute.)

[8] A detailed review of the technical requirements for the application of section 84.1 is beyond the scope of this article.

[9] Generally speaking, ACB is determined in accordance with section 54. For purposes of section 84.1, ACB does not include certain tax-preferred additions to ACB (e.g., created from a prior lifetime capital gains deduction (see section 110.6) claim or reflecting "V-day" (pre-January 1, 1972) adjustments to ACB), and this adjusted ACB concept is sometimes called "hard" ACB.

[10] Bill C-208 also introduced changes to subsection 55(2), which will not be addressed in this article.

[11] As those terms are defined in subsection 110.6(1).

[12] For a brief history of the development of Bill C-208 see Oakey, "The Finance Strikes Back", July 6, 2021, All About Estates (https://www.allaboutestates.ca/bill-c-208-intergeneration-transfers/).

[13] Some of the "warts" have been written about and discussed. For example, see Nichols and Horning, Wolters Kluwer ("CCH") 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.

While the relief provided by Bill C-208 is a good start in eliminating the Section 84.1 Penalty, unfortunately, the narrow class of qualifying purchasers will result in there continuing to be many non-arm's length intergenerational succession planning situations that will remain subject to the Section 84.1 Penalty.

Amendments to Section 84.1 In Brief

Deemed Arm's Length Conditions and Claw-back Provisions

New paragraph 84.1(1)(*e*) deems a taxpayer (i.e., the owner-manager) and an otherwise non-arm's length purchaser corporation to be dealing at arm's length if:

(i) the purchaser corporation is controlled by one or more children or grandchildren of the taxpayer;

(ii) the children or grandchildren of the taxpayer are 18 years of age or older; and

(iii) the purchaser corporation does not dispose of the Qualifying Shares within 60 months of the purchase

(collectively, the "Deemed Arm's Length Conditions").

However, pursuant to new paragraph 84.1(2.3)(*a*), relief from the Section 84.1 Penalty will be denied if, other than in respect of a disposition arising by "reason of death", the Qualifying Shares are subsequently disposed of during the 60-month period following a purchase of Qualifying Shares.[14]

Lastly, new paragraph 84.1(2.3)(*b*) of the Act results in a claw-back of the CGE in subsections 110.6(2) or (2.1) when the subject corporation has taxable capital exceeding $10 million.

Administrative Requirements

Even where a sale of Qualifying Shares is made to a corporate purchaser that meets the Deemed Arm's Length Conditions and there is no other claw-back in benefits applicable to the transaction, the owner-manager must still ensure that the Administrative Requirements in paragraph 84.1(2.3)(*c*) are adhered to. In particular, the taxpayer must "provide the Minister with an independent assessment of the fair market value of the [Qualifying Shares] and an affidavit signed by the taxpayer and by a third party attesting to the disposal of the [Qualifying Shares]."

Time will tell, but these Administrative Requirements may prove to be costly and, for many taxpayers, difficult to comply with.

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[14] Subject to complex tracing rules in subparagraph 84.1(2.3)(a)(ii) that are beyond the scope of this article.

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