THE CANADIAN BAR ASSOCIATION
L'ASSOCIATION DU BARREAU CANADIEN

CHARTERED PROFESSIONAL ACCOUNTANTS CANADA
COMPTABLES PROFESSIONNELS AGRÉÉS CANADA

The Joint Committee on Taxation of
The Canadian Bar Association
and
Chartered Professional Accountants of Canada

Chartered Professional Accountants of Canada, 277 Wellington St. W., Toronto Ontario, M5V3H2
The Canadian Bar Association, 500-865 Carling Avenue Ottawa, Ontario K1S 5S8

October 2, 2017

Department of Finance Canada
90 Elgin Street
Ottawa, ON K1A 0G5

Sent by email to fin.consultation.fin@canada.ca

Re: July 18, 2017: Part D of *Tax Planning Using Private Corporations* – "Converting Income into Capital Gains" Proposals

The Joint Committee on Taxation of the Canadian Bar Association and Chartered Professional Accountants of Canada (the "**Joint Committee**") is pleased to enclose its submission with respect to the proposals contained in Part D of *Tax Planning Using Private Corporations* - Converting Income into Capital Gains - released by the Department of Finance on July 18, 2017 (the "**Proposals**").

This submission is one of three submissions prepared by the Joint Committee. Other submissions address the legislative proposals regarding income sprinkling and the proposals regarding the tax treatment of passive income earned by private corporations.

The Joint Committee brings together members of Canada's legal and tax communities to evaluate and offer the federal government input on tax laws. For more than 70 years, this collaboration of CPA Canada and the Canadian Bar Association has regularly offered detailed suggestions to the Department of Finance on the technical aspects of new tax legislation. We also suggest improvements to simplify and improve the technical aspects of current tax laws. Our recommendations are founded on the actual experience of the members of the two professional societies as practitioners.

The Proposals involve amendments to section 84.1 and the introduction of a new section 246.1 to address concerns regarding the conversion of a private corporation's surplus (as defined in general terms in the Proposals) into tax-exempt, or lower-taxed, capital gains.

The stated objective of the Proposals is to address "tax loopholes" and end "tax planning strategies that give unintended advantages to some high-income earners at the expense of other Canadians" to protect the fairness of the tax system. However, the Joint Committee is concerned that in many situations the Proposals, as currently envisaged, introduce a different kind of "unfairness" into the Act for Canadian owners of private businesses and have the potential to produce other unintended effects on taxpayer behaviour, including, for example, incentivizing taxpayers to sell private corporation shares at an early opportunity rather than retaining them in their family and focusing on long-term growth.

The Joint Committee believes that the Proposals represent a fundamental change to longstanding Canadian tax policy in this area, and will further complicate the Act as it concerns corporate distributions and produce significant uncertainty regarding the tax implications of common transactions. The Proposals are intended to apply with immediate effect on July 18, 2017, but the Joint Committee is concerned that in many cases they could apply in a manner that may be inconsistent with the legitimate settled expectations of taxpayers.

Therefore, the enclosed submission recommends that the Proposals be withdrawn, and that an Advisory Panel be engaged to study in a comprehensive manner, in consultation with all relevant stakeholders, the treatment of distributions to shareholders of private corporations, so that further consideration of the potentially adverse effects of the Proposals, and possible alternative measures or approaches, can be properly undertaken.

The submission sets out our concerns regarding the impact of the Proposals on taxpayers and various technical deficiencies or uncertainties that we have noted, provides a number of illustrative examples, and makes a number of recommendations regarding how some of these concerns and technical issues might be addressed if the Proposals are advanced in their current form. Based on the many concerns identified, and the significance of the tax policy change underlying the Proposals, however, the submission recommends that the effective date of the Proposals be deferred to allow taxpayers appropriate time to properly determine and plan for the implications of this change, and recommends certain transitional and/or grandfathering rules that should be provided.

A number of members of the Joint Committee and others in the tax community have participated in this submission and have contributed to its preparation, including in particular:

- Bruce Ball (Chartered Professional Accountants of Canada)
- David Baxter (Thorsteinssons LLP)
- R. Ian Crosbie (Davies Ward Phillips & Vineberg LLP)
- David Elrick (BDO Canada LLP)
- Ken Griffin (PricewaterhouseCoopers LLP)
- Gabe Hayos (Chartered Professional Accountants of Canada)
- Steve Landau (Ernst & Young LLP)
- K. A. Siobhan Monaghan (KPMG Law LLP)
- Angelo Nikolakakis (EY Law LLP)
- Ken Saddington (Goodmans LLP)
- Michael Saxe (MNP LLP)
- Mitchell Sherman (Goodmans LLP)
- Mike Smith (Deloitte LLP)
- Terry Speiss (MNP LLP)
- Anthony Strawson (Felesky Flynn LLP)
- Marie-Emmanuelle Vaillancourt (Davies Ward Phillips & Vineberg LLP)
- Dave van Voorst (Ernst & Young LLP)
- Gwen Watson (Torys LLP)
- Linda Woo (Grant Thornton LLP)

We would like to thank you for your consideration of this submission. Once you have had an opportunity to review it, we would be pleased to meet with you to explore our concerns in more detail.

Yours very truly,

Kim G. C. Moody
Chair, Taxation Committee
Chartered Professional Accountants of Canada

Jeffrey Trossman
Chair, Taxation Section
Canadian Bar Association

c.c.: Paul Rochon, Deputy Minister, Department of Finance Canada
Andrew Marsland, Senior Assistant Deputy Minister, Tax Policy Branch, Finance Canada
Brian Ernewein, General Director, Tax Policy Branch, Finance Canada
Ted Cook, Tax Policy Branch, Finance Canada

Joint Committee Submission on the "Converting Income into Capital Gains" Proposals described in *Tax Planning Using Private Corporations* dated July 18, 2017 (the "Consultation Paper")

Table of Contents

1. Introduction and general comments

The Joint Committee has studied the Consultation Paper, and the draft legislation and Explanatory (Technical) Notes (the "**Explanatory Notes**") released in connection therewith, dealing with the so-called "conversion of income into capital gains", and has developed a series of observations and recommendations contained in this submission.

The policy concerns described in the Consultation Paper, and the measures to address these concerns, through proposed amendments to section 84.1 and the introduction of new section 246.1, deal with what is referred to as "surplus stripping". Although the *Income Tax Act* (Canada) (the "**Act**") already contains provisions that address surplus stripping, the Consultation Paper suggests that the language of section 84.1 in particular is problematic in that it prevents only certain surplus stripping and "does not apply to transactions that avoid its specific terms". Accordingly, the amendments attempt to address what has been described as "legal, but unfair" surplus stripping. However, neither the Consultation Paper nor the Explanatory Notes attempt to define with any precision what exactly this is intended to mean. The perceived concerns are described in different ways in different sections of the Consultation Paper and the Explanatory Notes.

In the Introductory and Summary sections of the Consultation Paper, the measures are described as aimed at "prevent[ing] the surplus income of a private corporation from being converted to a lower-taxed capital gain and stripped from the corporation." Section D of the Consultation Paper contains more detail, but focuses on the principle of "tax integration" that underpins the current scheme of the Act as it relates to the taxation of income earned through a private corporation; that is, our "tax system is designed so that the combined corporate and personal tax paid on income earned through a corporation and distributed as a dividend to an individual shareholder is roughly equivalent to the income tax that would have been paid if the income had been earned directly by the individual." This is accomplished in part by the dividend "gross-up" and tax credit mechanism for individuals, which in theory reduces personal tax on dividend income to account for corporate income tax already paid on that income. The Consultation Paper states that integration can fail[1] if "corporate surplus is paid out in the form of tax-exempt, or lower-taxed, income", and then goes on to define "surplus stripping" for purposes of the Consultation Paper as the (successful) conversion of "corporate surplus that should be taxable as dividends, or salary, into lower-taxed capital gains." In this context, the Consultation Paper indicates that "in general terms", the corporate surplus of a corporation "is made up of its accumulated after-tax earnings and unrealized corporate value minus its liabilities."

The system of integration also addresses capital gains earned or realized by a corporation, through the combined effect of the capital dividend rules and the refundable tax system for

[1] Integration might be viewed as having failed where it is not achieved. That is, the integration system produces a combined personal and corporate tax burden on income from a particular source that is lower (or higher) than that which would have been paid by an individual earning such income directly.

corporate investment income. Therefore, the proper functioning of the system of integration recognizes that a related portion of corporate surplus attributable to capital gains (i.e., the untaxed portion) may be distributed to shareholders in a manner that maintains the capital gain treatment (i.e., as a capital dividend).

While the system of integration might be considered to have failed where an individual shareholder realizes a capital gain on an arm's length sale of shares, the value of which is based in part on after-tax retained earnings of the corporation, this treatment has been accepted as a matter of tax policy where the purchaser deals at arm's length with the vendor (such that the sale is "genuine").

Whether integration is achieved in respect of business income earned through a corporation, is dependent on a number of factors and assumptions, including the assumption that corporate income earned in a particular year is fully distributed to the individual shareholders in that year. The reality is that after-tax corporate earnings are often reinvested in the business by the corporation rather than being distributed immediately. (Indeed, the government has sought to encourage such behaviour by reducing corporate tax rates over the past 20 years as an incentive for companies to grow.) Until 2006, when the "eligible dividend" regime was introduced, full (theoretical) integration of business income earned by a corporation in excess of the annual "small business threshold"[2] did not exist. As personal tax rates on dividend income have increased significantly in recent years (to reflect the decreasing corporate tax rates and seek to maintain integration), current dividend distributions of corporate income earned some time ago, but retained in the corporation, face a greater effective tax rate than the current top marginal personal rates. For example, corporate income earned ten years ago, and taxed at the then applicable general corporate rate, but distributed to an individual shareholder as a dividend in 2017 results in an effective overall tax rate of approximately 61%.[3] Accordingly, any determination as to whether a particular distribution by a corporation results in "proper" integration is complex.[4]

Since 1972, when capital gains first became taxable, effective tax rates applicable to capital gains have varied considerably, mainly as a result of changes to the inclusion rate.[5] Over that same period, the difference between the top marginal personal tax rates on capital gains and those applicable to dividends has also varied, with capital gains rates sometimes being higher.[6]

---

[2] The annual amount, currently $500,000, of taxable income for an associated group of Canadian-controlled private companies (with total "taxable capital" less than $10 million) that is subject to corporate tax at reduced rates. The annual threshold has increased periodically over time from $50,000 in 1972.

[3] Using the Ontario 2007 corporate tax rate of 36.12% and the Ontario 2017 top personal eligible dividend tax rate of 39.34%.

[4] The calculation could also be affected by changes in the individual's provincial residence over the relevant period.

[5] The increases in 1988 and 1990, and subsequent decrease in 2000.

[6] For example, using Ontario rates, in 1972-1977 the dividend rate was approximately 16-17% higher than the capital gain rate, in 1982-1989 the rates were nearly identical (except for 1987), in 1990-1999 the capital gain rate was approximately 4% higher than the dividend rate, in 2001-2005 the dividend rate was approximately 8% higher than the capital gain rate, in 2006-2010 the eligible dividend rate was 0-3% higher than the capital gain rate, and

It appears clear that current section 84.1 was not intended to apply in all circumstances in which gains are recognized on a non-arm's length transaction, and thereby converted into adjusted cost base ("**ACB**"), which is subsequently used to increase corporate paid-up capital ("**PUC**") such that corporate surplus can be distributed to individual shareholders free of additional tax. The Consultation Paper correctly observes that a form of this indirect surplus stripping can be achieved, through an individual vendor's sale of private company shares to another individual who then transfers the shares to another private corporation,[7] but only to the extent that the gain realized on the first sale was not tax-free because of the lifetime capital gains exemption (the "**LCGE**") or because it had accrued prior to 1972.

It is true that section 84.1 may apply to convert the full amount of an accrued gain on shares into a deemed dividend if the shares are transferred by an individual directly to a Newco for non-share consideration ("boot"), or to reduce the PUC of shares issued by Newco in exchange for the transferred shares. However, where related (or other non-arm's length) persons have realized capital gains that have become part of the current ACB of the shares, that ACB is not reduced for purposes of section 84.1 where the taxpayer can establish that the LCGE has not been claimed in respect of those gains and the gains accrued after 1971. The "modified ACB" rule in paragraph 84.1(2)(a.1) is concerned with "conversion of dividends into capital gains" only in situations where the capital gain has not been taxed at all.

A comparison of existing section 84.1 to section 212.1, a similar provision but applicable to non-resident transferors, indicates that Parliament understood that the nature of, and potential opportunities for "tax avoidance" in the area of, surplus stripping vary depending on the relevant fact pattern. Section 212.1 gives no recognition for transferor ACB, whether derived in an arm's length or non-arm's length transaction, because it recognizes that, absent section 212.1, a non-resident vendor could "step up" its ACB through a gain recognition transaction that would not be taxable in Canada (either because the shares are not "taxable Canadian property" or because of an exemption under a Treaty) and thereby effectively convert subsequent dividends (otherwise subject to Canadian withholding tax) into tax-free capital gains. This rule is consistent with the limited focus of section 84.1, in a Canadian resident context, on preventing the conversion of dividends into tax-free capital gains.

Thus, it appears a policy decision was made in both the domestic and cross-border context to apply the surplus stripping rule only to those situations where tax-free gains could otherwise be used to avoid subsequent deemed dividends. In view of the imperfect nature of integration and the varying differences between effective capital gain and dividend tax rates over the

---

since 2011 the excess of the eligible dividend rate over the capital gain rate has climbed from approximately 5% to nearly 12.5% currently.

[7] More generally, what might amount to "surplus stripping" on transfers of shares by an individual directly to another private corporation is prevented under section 84.1, but only in certain (very specifically defined) circumstances.

years,[8] we believe that this policy decision was (and continues to be) reasonable and that existing section 84.1 represents a balanced approach to the perceived problem of domestic surplus stripping.

Even when section 84.1 applies to produce a deemed dividend, it does not mandate that the resulting dividend be a taxable dividend. Private corporations are generally entitled (or, in the context of subsection 88(2), encouraged) to elect to treat the deemed dividend as a capital dividend to the extent of the corporation's capital dividend account balance (subject to specific anti-avoidance rules).

The Consultation Paper states that the policy underlying section 84.1 is to "ensure that a corporate distribution is properly taxed as a taxable dividend" (emphasis added) when corporate shares are transferred by an individual to a non-arm's length corporation. This statement appears to suggest that all "surplus" of a corporation necessarily represents current (or future) after-tax income, to the exclusion of "capital" value arising from prior, or future potential, dispositions of capital property by the corporation.

The Act today, as it relates to the treatment of direct or indirect distributions from a private corporation to a shareholder, is already extremely complex. In addition to the provisions related to eligible and so-called "non-eligible" taxable dividends, and the rules (and various specific anti-avoidance rules) related to capital dividends, a host of other rules are potentially relevant. These include, for example, provisions in section 84, subsections 69(5) and 88(2) dealing with winding-up, section 15 dealing with shareholder benefits more generally, and numerous provisions (including sections 84.1 and 212.1) that govern or restrict the computation of PUC in various situations (and therefore can produce or affect the calculation of deemed dividends or capital gains where distributions are made on a reduction of stated capital), as well as section 55 addressing situations in which corporate dividends can be recharacterized as capital gains.

It is therefore perhaps not surprising that the Consultation Paper does not make any attempt to define or describe how, under the current scheme of the Act, one would go about determining what portion of corporate surplus (as the Consultation Paper defines it) "should" be distributed to an individual shareholder in the form of taxable dividends or paid out as salary,[9] nor whether, or in precisely which circumstances, such distributions should be required (or deemed) to be made in priority to other types of distributions.

Rather, the Consultation Paper discusses existing section 84.1, its perceived inadequacy to address all forms of non-arm's length surplus stripping, and the perceived need to expand its ambit (and to introduce an additional anti-stripping rule, in proposed section 246.1).

---

[8] Without more fundamental tax reform, it seems reasonable to assume that such differences will persist in the future, but in varying amounts as tax rates are inevitably increased or decreased from time to time.

[9] Although the Consultation Paper appears to suggest that "corporate surplus" should be paid to an individual shareholder as salary, as the payment of a salary normally would be expected to reduce the corporation's earnings before tax, we have assumed this is not intended.

Both section 84.1 (existing and proposed) and new section 246.1 deem a taxable dividend to be realized in an attempt to prevent surplus stripping. By defining surplus as after-tax earnings PLUS unrealized corporate value, the implicit presumption appears to be that unrealized corporate value will be realized at some point as income, such that it is appropriate that a "strip" of that surplus be taxed as a dividend. The Joint Committee observes that it seems difficult to reconcile this starting presumption with the fact that we have a capital gains concept at all. If a shareholder sells shares to a third party for a gain, the "surplus" (as defined in the Consultation Paper) has been converted into a capital gain for the shareholder. It is an inevitable result that surplus (as broadly defined) will be "stripped" whenever a capital gain on a share is realized. On the assumption that the government does not intend to effectively eliminate the ability to receive capital gain treatment for tax purposes on a disposition of private corporation shares, the realization of a capital gain (i.e., a "surplus strip" based on the broad notion of that concept articulated in the Consultation Paper) cannot be inappropriate. There must be "something else" that causes a capital gain to be viewed as an inappropriate surplus strip.

That "something else" is not articulated clearly or consistently in the Act and, in our view, new section 246.1 will not improve the situation. Therefore, we believe that surplus stripping challenges will continue to be difficult for the taxing authorities and taxpayers will continue to struggle to know whether they are acting in a manner that is consistent with the object, spirit and purpose of the rules. We reach this conclusion because section 246.1 implies that the "something else" is an intention to obtain a better tax result. Even if that is a sensible basis on which to distinguish good surplus strips from bad (which we question), the Act obviously very deliberately taxes capital gains at a lower rate than dividends (and taxpayers can be taken to know that to be the case), which implies that an intention to obtain a better tax result by realizing a capital gain is <u>not</u> the "something else" that causes a surplus strip to be bad. If an objective of the government in proposing section 246.1 is to support GAAR challenges of surplus strips in the future, in our view it is unlikely to be effective, or at least as effective as it could be if the rule were to be revised to address the circumstances that are actually considered inappropriate. Moreover, because the rule has such uncertain application, it could apply in circumstances that are unintended while at the same time being ineffective at discouraging taxpayers from undertaking transactions that the government may be intending to prevent.

The Joint Committee strongly believes that these proposed amendments will further complicate the Act as it concerns corporate distributions, and produce significant uncertainty regarding the tax implications of common transactions. The stated objective is to address "tax loopholes" and end "tax planning strategies that give unintended advantages to some high-income earners at the expense of other Canadians" to protect the fairness of the tax system. However, the Joint Committee is concerned that in many situations the proposals, as currently envisaged, introduce a different kind of "unfairness" into the Act for Canadian owners of private businesses and have the potential to produce other unintended effects on taxpayer behaviour, including, for example, incentivizing taxpayers to sell private corporation shares at an early opportunity rather than retaining them in their family and focusing on long-term growth.

In summary, we believe that the proposed amendments to section 84.1 and new section 246.1 represent a fundamental change to longstanding tax policy. While it is open to the government to do so, the Joint Committee believes that it would be prudent to take some additional time to consider the potentially adverse effects of the proposals and possible alternative measures or approaches that could be adopted. **Accordingly, we recommend that the current proposals be withdrawn, and that an Advisory Panel be engaged to study in a comprehensive manner, in consultation with all relevant stakeholders, the treatment of distributions to shareholders of private corporations.** The Advisory Panel could consider how best to delineate and address concerns regarding surplus stripping without imposing adverse tax effects on all non-arm's length shareholder transactions or creating unnecessary uncertainty regarding private corporation distributions. In this regard, we would note that the Chartered Professional Accountants of Canada ("**CPA Canada**") and a number of other organizations have proposed a comprehensive review of the tax system, and the analysis discussed above could be a cornerstone of such a review.

Finally, any changes to be implemented as a result of this study should be introduced prospectively and with appropriate transitional rules or grandfathering provisions so that the treatment of existing and historical transactions are not, in effect, modified without notice to taxpayers.

In the balance of this submission, we set out our concerns regarding the impacts of these proposals on taxpayers, and various technical deficiencies or uncertainties that we have noted. As a result of these many issues, and having regard to the significance of the tax policy change being proposed, we recommend that the effective date of the measures be deferred to allow taxpayers appropriate time to properly determine and plan for the implications of this change, and that appropriate transitional or grandfathering rules be provided to avoid what, in many cases, would otherwise be the application of the measures in a manner that is inconsistent with legitimate settled expectations. Such an approach would be more consistent with common practice in our tax system when new policies[10] or rate increases[11] are proposed, as opposed to when technical loopholes are closed.

---

[10] Including, to note just a few examples, the deferred implementation of the capital gain inclusion rate increase announced in 1987, and a variety of more recent changes to rules in an international business context (such as introduction of the "foreign affiliate dumping" provisions, and changes to the various back-to-back financing rules). These changes were announced with a later effective date, recognizing that taxpayers need time to consider and react to new policy measures, notwithstanding that some taxpayers affected by these changes might have been considered to have been enjoying "unintended tax advantages".

[11] In many respects, for example, the proposed changes to section 84.1 will result in a significant tax increase for estates and their beneficiaries in respect of interests in private corporations.

2. Comments regarding proposed amendments to section 84.1

The proposed amendments to section 84.1 seek to prevent individual taxpayers from using non-arm's length transactions that result in an increase in the ACB of corporate shares in order to avoid the application of section 84.1 on a subsequent transaction. This would be accomplished by expanding the existing rules in subsection 84.1(2) that restrict the recognition of ACB for purposes of section 84.1. The rule will provide that in computing the so-called "hard cost" of a share, the ACB will be reduced by any capital gain realized after 1984 (technically, an "amount determined after 1984 under subparagraph 40(1)(a)(i)") in respect of a previous disposition of the share (or a share for which the share was substituted) by the individual or another non-arm's length individual.

However, application of the expanded section 84.1 will not be limited to situations where taxpayers have entered into "schemes that seek to avoid section 84.1" for the purpose of extracting funds from a corporation that, under some objective measure, "should" otherwise have been distributed from the corporation in the form of a taxable dividend. In that sense, the proposed amendment may be seen as compounding the current "overreach" of the hard cost limitation rule in subsection 84.1(2) to genuine business transactions between family members.

It has long been recognized that the application of section 84.1 to all transactions involving non-arm's length individuals, regardless of motivation or purpose, prevents access to the LCGE on a related party share disposition, and therefore more tax is payable as compared to sales to arm's length purchasers. The Joint Committee is concerned that expanding the rules as proposed will produce a greater impediment to the transfer of family businesses from one member to another, whether from one generation to another or between siblings (and during lifetime or post-mortem), with the result that our tax system would favour third-party sales. As illustrated in the examples below, families that wish to retain private corporation share interests within the family, rather than sell to a third-party (even if possible as an alternative), will face an additional tax burden as a result of these proposed changes. This seems inconsistent with the stated intention of the proposed changes - "to help businesses grow, create jobs and support their communities" and, in our view, does not seem necessary to "increase[ing] the fairness of the tax system." These proposed changes apply not only to "wealthy" Canadians, but rather will increase the tax cost of succession for interests in private corporations regardless of value or income-generating potential.

a) Application of proposed section 84.1 in a post-mortem context

Example 1 – Typical Estate Freeze

When an individual dies, the Act provides that the individual is deemed to dispose of all his or her property, including private company shares, at fair market value (subject to certain exceptions, such as where property is left to a spouse or spousal trust).

Assume the following common scenario: Mrs. X owns preferred shares in an Opco, having a fixed value of $5 million. The preferred shares were received when Mrs. X implemented a typical estate freeze 10 years ago (at age 55) and converted her common shares into the preferred shares. Assume the ACB and PUC of the preferred shares held by Mrs. X is nominal. At that time, Opco issued new common shares to her 35 year old daughter. Mrs. X is no longer working in the business, and fully transitioned management of the business to her daughter many years ago. What are the estimated tax consequences to Mrs. X and her estate on her death, assuming Mrs. X leaves her preferred shares to her daughter under her will?

Current Rules

Prior to July 18, 2017, Mrs. X would have a capital gain of $5 million in her final personal return, and her estate would have an estimated income tax liability of approximately $1,261,000 (assuming Manitoba tax rates and that Opco's preferred shares do not qualify for the LCGE). In addition, before July 18, 2017, the Estate or Mrs. X's daughter could have implemented a so-called "pipeline strategy"[12] to avoid the "double tax" that would otherwise arise if the Opco preferred shares are retained, the value inherent in Opco's preferred shares is realized by (and taxed in) Opco over time, and the after-tax income or taxable gains distributed to the Estate or Mrs. X's daughter on redemption of the shares. The Estate could potentially have elected to pay the $1,261,000 tax payable on death over 10 years, with the annual instalments being funded by cash flow from the Opco business distributed on the periodic redemption of preferred shares. The Canada Revenue Agency (the "CRA") has, over the years, provided numerous rulings that this type of planning generally was acceptable and carried no avoidance concerns.[13]

Proposed section 84.1

Under proposed section 84.1, neither the Estate nor Mrs. X's daughter is permitted to employ "pipeline" planning to avoid double tax on death, because for purposes of section 84.1 the ACB to the Estate or Mrs. X's daughter will be reduced by the capital gain deemed to be realized by Mrs. X on death.[14] Therefore, while the Estate tax payable on the $5 million capital gain remains approximately $1,261,000,[15] an additional $2,284,000 of tax will be payable by the

[12] A pipeline strategy essentially allows the Estate or Mrs. X's daughter to transfer the Opco shares to a Newco, and receive a promissory note or high PUC shares from Newco equal to the fair market value of the preferred shares on Mrs. X's death (i.e. Mrs X's ACB plus the capital gain realized on her death). The promissory note, or amounts paid on the reduction of the PUC, could be paid out over time without any additional tax to the Estate or Mrs. X's daughter (subject to the possible application of subsection 84(2) in cases where the business of Opco is immediately liquidated to fund the distributions).

[13] Subject, relatively recently, to concerns regarding the possible application of subsection 84(2) where the business of the "Opco" is wound up or discontinued upon or shortly after implementation of the post-mortem restructuring. The concern was not whether section 84.1 could be considered to have been "abused" or improperly avoided, and generally was satisfied by requiring a "continuity of the business" period of at least one year.

[14] It appears likely that in most cases a taxpayer's Estate will be considered to have acquired the shares from a non-arm's length person (the taxpayer), if for no other reason than the fact that the Estate pays no consideration for the shares.

[15] Assuming Mrs. X was not fully "active" in Opco's business for a number of years prior to implementing the freeze, proposed changes to subsection 120.4(4) (under the "Income Sprinkling" proposals) might apply deem all or a portion of Mrs. X's capital gain from the disposition of shares on death to be a taxable dividend. This could

Estate or Mrs. X's daughter as the preferred shares are redeemed over time.[16] In total, the tax payable in respect of Mrs. X's $5 million of preferred shares potentially increases from $1,261,000 to $3,545,000 (an increase in the effective tax rate from approximately 25% to 70%). In this situation, the Estate would have a capital loss if preferred shares are redeemed prior to being distributed to Mrs. X's daughter.

In contrast, if the shares are distributed to the daughter by the Estate and subsequently redeemed, the daughter will have capital losses that are "suspended" under subsection 40(3.4) (because she owns the common shares of Opco), until such future time as she is no longer "affiliated" with Opco (e.g., Opco is liquidated, she sells Opco to a third party, or ultimately on her death). Whether she will enjoy any actual tax benefit at such time from the capital losses is uncertain at best; they cannot be applied against the Estate's capital gain or the dividend income received on redemption of the preferred shares. In addition, in either case, it is possible that a portion of the capital loss will be denied under subsection 112(3.2), to the extent that Opco elects that a portion of the deemed dividends on redemption of the preferred shares be treated as capital dividends.

It is possible that the Estate could avoid the double tax if the preferred shares are redeemed within one year of death and an election is made under subsection 164(6) to carry back the capital loss to offset the capital gain realized on death. However, post-mortem planning relying on subsection 164(6) may not be practical, for a number of reasons:

(i.) The subsection 164(6) election can be used only if made within the first taxation year of the Estate following death. However, in many cases, one taxation year is not sufficient to decide and implement the necessary steps to realize the capital loss, so that the election can be made, due to such matters as family grieving, complicated Estate administration, or pending or potential Estate litigation.

(ii.) It may not be possible for the Estate to require the shares to be fully redeemed within one taxation year (depending, for example, on the terms of the shares, related shareholder agreements, or cooperation from other shareholders). Opco may not have sufficient liquid assets to redeem the shares (or that can be used for that purpose without destabilizing the business). If Opco seeks to borrow to redeem the shares (or issue an interest-bearing note), resulting interest expense could be non-deductible, or financing restrictions may simply limit Opco's ability to do so.

---

increase the Estate tax payable on Mrs. X's death from $1,261,000 to as much as $2,250,000. Furthermore, it appears that Mrs. X would nonetheless be considered to have a "capital gain determined under subparagraph 40(1)(a)(i)", such that the Estate would be unable to undertake post-mortem pipeline planning, because proposed subsection 120.4(4) only applies to deem twice the amount of Mrs. X's "taxable capital gain", which is calculated under section 39, to instead be a taxable dividend. We assume that this result is not intended and that amendments should be made to ensure that the corresponding ACB of the shares to the Estate (or a beneficiary) will be treated as "hard cost" for purposes of section 84.1 in the future.

[16] Assuming that the resulting deemed dividends are taxable at the top marginal personal tax rate.

(iii.) The subsection 164(6) election can be used only if the Estate qualifies as a Graduated Rate Estate (GRE), and not all Estates qualify.

(iv.) Pursuant to the proposed changes to subsection 120.4(4), all or a portion of the capital gain arising on the deemed disposition of shares on death may be recharacterized as a taxable dividend and considered to be "split income". We assume that the draft rule will be amended so that the Estate's ACB will not be treated as "soft cost" for purposes of section 84.1 in respect of any amount that is recharacterized as a dividend under subsection 120.4(4), so that the Estate would be able to use a pipeline strategy to access equivalent corporate funds without additional tax. This would avoid the double tax that would otherwise arise when such amounts are subsequently distributed from the corporation. However, the exact portion, if any, of the gain that might be subject to the split income rules may be uncertain, given the nature of the proposed tests under those rules. Accordingly, whether, or the extent to which, the Estate will be able to properly implement pipeline planning in respect of what would be an uncertain amount of modified ACB may be unclear. Therefore, it may continue to be necessary to rely on the redemption of shares, creation of a capital loss and subsection 164(6) carry back election to avoid double tax in respect of whatever portion of the capital gain on death is ultimately determined not to be recharacterized under subsection 120.4(4). The existing one taxation year time limit may be a significant impediment to doing so.

(v.) Various stop loss rules like subsection 40(3.6) also may limit the use of a loss carryback in an Estate situation. Although subsection 40(3.61) is meant to reduce the application of the "stop loss rules" where an Estate elects to carry back a loss under subsection 164(6), other situations may arise where the stop loss rules do in fact apply. For example, if the Estate realizes other capital gains in its first taxation year, a capital loss from the share redemption may be suspended under these rules.[17]

(vi.) Subsection 40(3.6) can apply to suspend post-mortem capital losses arising from share redemptions in other circumstances. For example, where shares were previously left to a spousal trust or are held in an alter-ego or joint partner trust, the Act deems such trust to have disposed of its assets at fair market value on the death of the settlor or surviving spouse. Subsection 164(6) planning is not available to these type of trusts. Because they must rely on the "normal" three-year loss carry back rule, the subsection 40(3.61) exception to subsection 40(3.6) will not apply. Accordingly, the options for these trusts now are (i) wind-up the corporation so that subsection 40(3.6) does not apply by virtue of paragraph 69(5)(d); or (ii) where there are other shareholders, or a winding up of the

[17] Subsection 40(3.61) provides relief only in respect of the amount of a capital loss to which an election under subsection 164(6) applies, but paragraphs (a) and (c) of the latter rule operate to limit the amount of a particular loss that can be carried back to the excess of total losses over total gains realized in the Estate's first taxation year.

corporation is not commercially practical, transfer the shares to a new holding company so those shares may be repurchased or redeemed prior to winding up the new holding company. To provide certainty as to the tax consequences in these circumstances, we suggest that Finance consider amending subsection 40(3.61) to include redemptions of shares held by spousal trusts, alter-ego or joint partner trusts.

However, even if the capital gain on death can be offset in the Estate by relying on subsection 164(6), the Estate's immediate tax liability of $2,284,000 represents an increase of over 81% compared to the tax that would have otherwise been payable under existing section 84.1, or should Mrs. X's daughter choose to sell Opco to a third party. (In the circumstances, it would not be reasonable to expect a sale of the preferred shares alone to an arm's length purchaser.) Mrs. X's daughter will be faced with a significant, life-altering decision that must be made in a very short timeframe (in many cases, a time that is already extremely stressful without having to contemplate such matters), but will have, at best, an immediate $1 million tax disincentive to keep the business.

Example 2 – Underlying Value Attributable to Capital Gain
Assume Mr. X is the sole owner of the common shares of Opco, which have a current value of $1 million and a nominal ACB and PUC. No other shares are outstanding. The value of Opco is derived from (i) land and building used in its business, with a value of $700,000 and an accrued gain of $500,000, and (ii) net working capital of $300,000. (Assume that the land has a fair market value of $600,000 and the full accrued gain of $500,000 – the building has ACB/UCC and FMV of $100,000.) Accordingly, the value of the Opco shares represents "retained after-tax business income" of $500,000 and unrealized capital gains of $500,000 on its land.

Following Mr. X's death, the beneficiaries of his Estate would like to continue to carry on the business. Mr. X would be deemed to have realized a $1 million capital gain on death, on which the Estate would pay tax of approximately $267,600 (using the Ontario top marginal rates). Currently, it would be typical for Mr. X's Estate to transfer the Opco common shares to a newly incorporated Holdco in exchange for new shares with an ACB and PUC of $1 million, reflecting the taxed capital gain on death. Opco and Holdco could then merge (either by winding-up Opco into Holdco, or through an amalgamation) and the ACB of the land could be "bumped" to its fair market value of $600,000, under section 88. In this way, the beneficiaries avoid incurring tax twice in respect of the same economic gain on the land (once on $500,000 of the gain realized on the deemed disposition of Mr. X's shares on his death, and a second time in the future when the land is sold). The beneficiaries also avoid incurring tax twice in respect of the accumulated after-tax business income, are in the same economic position as if they had acquired the Opco business in an arm's length purchase (using proceeds received from the Estate following a notional arm's length sale of the Opco shares on the death of Mr. X), and are treated no differently for tax purposes than if the Estate had sold Opco to a third party.

As a result of the proposed changes to section 84.1, although the Estate could still use the Holdco structure to "bump" the ACB of the Opco land to its fair market value, the PUC of the

Holdco shares will not be increased. Therefore, although Opco itself may not incur tax on the accrued gain, in a future sale of the Opco land, the beneficiaries will face a future tax cost when those proceeds are distributed from Opco. The total tax payable on future distributions of the $1 million value of Opco would be as much as approximately $453,000, in addition to the $267,600 tax already paid on Mr. X's death. To avoid this double tax, the Estate would need to receive $1 million of preferred shares from Holdco on the initial transfer of Opco shares. The preferred shares could be redeemed, resulting in a $1 million taxable dividend and $1 million capital loss to the Estate, with the capital loss carried back under subsection 164(6) to reduce Mr. X's gain on death. Under this plan, the Estate's tax liability would increase to approximately $453,000, and the Estate would effectively be paying tax at dividend rates in respect of the underlying economic capital gain on the land – in effect, converting capital gains into income, the opposite of the "mischief" that the proposed change to section 84.1 is intended to prevent.

Alternatively, Opco might transfer its land to a Newco, to trigger the accrued $500,000 capital gain. On redemption of the Opco preferred shares, a capital loss would arise and could be carried back under subsection 164(6), and Opco could elect to treat $250,000 of the resulting deemed dividend as a capital dividend so that the effective capital gain tax rate on the $500,000 underlying accrued gain on the land is essentially maintained[18]. While on these facts, subsection 112(3.2) should not limit the capital loss that could be carried back, this could be a restriction in other fact patterns. However, we are concerned that the Opco capital dividend may be recharacterized under proposed section 246.1 (see our separate comments under proposed section 246.1 in this regard), such that it is unclear whether the Estate could successfully take these steps to mitigate the tax. Even if not subject to proposed section 246.1, this alternative results in a significant increase in the tax cost to the Estate, as compared to the tax cost of simply selling the shares, particularly given that a full "distribution" of Opco's retained business income as taxable dividends may not have otherwise occurred for many years.

Finally, in theory at least, the Estate could simply have caused Opco to wind up following Mr. X's death. In that event, subsection 88(2) would have applied to produce essentially the same results as described in the preceding paragraph, because Opco's land would be deemed to be disposed of at fair market value and the Estate would be deemed to have received a $250,000 capital dividend under subparagraph 88(2)(b)(i), assuming the Estate so elects, and a taxable dividend for the remainder of Opco's value. (Although not entirely clear, we presume that the intention is that proposed section 246.1 would not apply in this event.) However, assuming that the beneficiaries want to continue to carry on the business (such that they would likely want the Estate to transfer the Opco business assets to a corporation once again), aside from being costly (incurring land transfer tax and various other expenses), a variety of business or legal reasons (contractual or potential liability exposure, etc.) would likely make this approach impractical.

[18] There would be some tax cost due to lack of perfect "integration".

Recommendation

Having regard to these simple examples, and considering that many Estate situations are in fact very much more complex and difficult to administer under current rules without incurring significant double taxation, we recommend that the proposed changes to section 84.1[19] not apply in respect of shares that are acquired in consequence of a taxpayer's death. The existing rules that apply on death, whereby the deceased is treated as having disposed of property as if sold at fair market value, should not be modified to effectively require the Estate to pay significantly more tax than what would be payable had the deceased instead sold the shares to an arm's length third party. In the context of the death of the shareholder, requiring immediate taxation of the full accrued gain on private corporation shares, as if that gain had been fully "converted" into dividends, where the corporate interests are to be retained for the long term post-mortem, seems inappropriately harsh.

At a minimum, modifications to existing subsection 164(6) should be made to address the issues noted above and broaden the ability of Estates and their beneficiaries to avoid double tax in a post-mortem context[20]. Alternatively, to avoid the need for complicated and expensive reorganization steps to accomplish this result, consideration should be given to simply allowing an Estate to elect to treat the accrued gain on the shares[21] as a dividend (in which case the Estate and its beneficiaries (and any other non-arm's length individuals at a future time) would be considered to have received full "hard ACB" for purposes of the subsequent application of section 84.1[22]).

A final alternative would be to allow the Estate to elect to treat the deceased as having received a pro rata distribution of its share of the underlying property of the corporation, as if it (and all of its connected subsidiaries) had been wound up under subsection 88(2) at that time and as if any amount that (i) could have been received as the deceased's share of a capital dividend out of the corporation's capital dividend account balance immediately before death, or (ii) represents the deceased's share of a capital gain that would have been deemed to be realized on a distribution of corporate property (other than gains on shares of connected corporations) on the notional winding-up, would be treated as a capital gain of the deceased rather than a taxable dividend or capital dividend. The Estate would also then be considered to have received full "hard ACB" for purposes of the subsequent application of section 84.1. Although admittedly more complicated and potentially raising significant valuation issues, this alternative might be a fair balance between the government's objective of preventing inappropriate surplus stripping in a post-mortem context without failing to recognize the nature of the underlying accrued gains.

---

[19] And, similarly, the proposed change to subsection 120.4(4).
[20] For example, subsection 164(6) could be modified to (i) extend the time limit for making the election to, say, the end of the third taxation year of the Estate and (ii) allow the election to be made in respect of an "elective disposition" as well as actual dispositions.
[21] Or perhaps, as discussed below, only that portion that represents "safe income" at the time of disposition.
[22] Additionally, an exception from subsection 84(2) should be provided where the Estate or its beneficiaries subsequently receive distributions of equivalent amounts directly or indirectly from the corporation.

As a more general comment, the issues to be addressed in the context of post-mortem taxation were very complicated before these proposals were announced. In our view, these issues should be corrected before the system is made more complicated. We would suggest that the death of a shareholder of a private corporation should not trigger a need for complex tax planning to avoid double tax.

b) Application of proposed section 84.1 to Inter-vivos family share transfers

In many cases, a business owner would like to transfer all or a portion of his/her business to his/her children, or to another family member. Having regard to current section 84.1, the business owners or the transferee must undertake a series of transactions so that the total after-tax cost is similar to that which would be paid if the business was sold to an arm's length third party. Two examples of the transactions that could be undertaken are: (1) The business owner undertakes an internal share reorganization prior to transferring his/her business to family members; or (2) The purchaser transfers the newly purchased shares to a holding company to facilitate the financing of the purchase (in the same manner as if the purchase was arm's length). These examples are illustrated below.

The illustrated transactions represent what would have been previously considered "standard planning", in respect of bona fide (or "genuine") related party business transfers. Proposed section 84.1 will now apply to these transactions resulting in additional tax. Accordingly, if these proposed rules are implemented, business owners will have a clear incentive to sell their business instead of keeping it in the family.

Example 3 – Reorganization Prior to Intergenerational Sale

Bob owns shares of a corporation ("Opco") carrying on a furniture business and wants to retire and pass on the business to his son and daughter (both of whom are currently active in the business). He specifically wants to sell the business to them rather than third parties due to their involvement in the business. Bob is planning to fund his retirement with the proceeds received from the sale of the furniture business, which is currently valued at $6,000,000. A significant portion of this value relates to the goodwill inherent in the business. (Assume the ACB and PUC of his shares is nil and Opco's income is taxed at the general corporate rate.) This value is similar to a recent offer Bob received from a business associate. However, Bob's children do not currently have the personal funds or available resources to purchase Bob's shares outright.

- Under the current rules, if Bob undertakes an internal share exchange and triggers the $6 million capital gain, does not claim the LCGE, and then transfers the Opco shares to a holding company incorporated by his children, he can receive in return a promissory note of $6,000,000 without additional tax. Bob will recognize a capital gain of $6,000,000 and will have taxes payable of $1,605,900 ($6,000,000 x 50% x 53.53% (the highest marginal tax rate for an Ontario resident)).

- Under the proposed rules, Bob will have no hard ACB for purposes of section 84 since his ACB will have been derived from a capital gain in respect of a previous disposition by him. Therefore, if Bob receives a $6,000,000 promissory note, that amount will be deemed to be a taxable dividend and will be subject to tax of as much as $2,718,000[23] ($6,000,000 x 45.3% (the highest marginal tax rate for ineligible dividends for an Ontario resident)).
- If Bob was to, instead, sell the business to an arm's length purchaser, whether before or after the amendments, he will be able to shelter some of the capital gain with his LCGE of $835,000 and the total taxes owing would be only $1,382,400 (i.e., ($6,000,000 - LCGE of $835,000) x 50% x 53.53%).

While before the amendments, he would have to forego the LCGE to sell to his children or a company owned by them, that is a relatively small amount ($223,500). Following the amendments, the difference between the arm's length sale and the sale to his children is $1,335,600 – nearly double the tax that would be payable on the arm's length sale.

Example 4 – Direct Sale to Children

Assume the same fact pattern as Example 3, except that Bob sells the shares of Opco directly to his children, and receives a $6 million promissory note as consideration. The children subsequently transfer the Opco shares into a new holding company and repay the promissory note to Bob over time using cash flow and the debt capacity of Opco.

- Under the current rules Bob recognizes a capital gain of $6,000,000 and, using the highest marginal tax rate for an Ontario resident, will pay total taxes of $1,605,900 ($6,000,000 x 50% x 53.53%).
- Over time, Opco must generate $8,163,265 of pre-tax earnings to fully fund the payment of the $6,000,000 promissory note, with $2,163,265 of tax paid ($8,163,265 x 26.5% Ontario corporate tax rate = $2,163,265 tax paid).
- The total tax paid by Bob and the Opco is $3,769,165 ($1,605,900 paid by Bob and $2,163,265 paid by the company) representing an effective tax rate of approximately 46%. The after-tax cash flow on the total earnings needed to fund the purchase is $4,394,100 ($8,163,265 pre-tax corporate earnings less $3,769,165 total tax paid).
- This same total tax would be paid if Bob sold the shares to an arm's length party. He would pay the same tax on the capital gain (or possibly less by using his LCGE). The purchaser could fund the purchase with the same amount of Opco pre-tax earnings.
- Alternatively, Bob might agree with the purchaser to sell the business as an asset sale. The purchaser would, in theory, be prepared to pay more for the assets, because a portion of the cost could be depreciated for tax purposes. Assuming that the goodwill value is $4,000,000, and the remainder of the transaction value represents net working capital and other assets that have no accrued gains, the purchaser might be willing to

[23] The tax would likely be somewhat lower, as Opco would probably have some GRIP balance (previously-taxed retained earnings that were subject to the "high" corporate tax rate), but a significant portion of the value of Opco is represented by "unrealized corporate surplus", such as the goodwill value in respect of which there would be no GRIP balance.

pay something like $6,500,000. Opco would realize a capital gain on the goodwill, which would allow Bob to receive after-tax personal cash of approximately $2.9 million (taking into account the combined effective corporate and personal tax on that gain) while leaving the remaining $2,500,000 in Opco to be invested to help fund his retirement (or to reinvest in other business ventures). Although Bob would have approximately the same total personal cash after tax if this amount were immediately distributed as a dividend, the arrangement would allow Bob to instead receive these remaining funds as taxable dividends over time potentially at reduced marginal tax rates (rather than having to pay tax on the full amount up-front at the top marginal rate), similar to how he might have received income distributions from the company over time had he remained involved with the business.

- Under proposed section 84.1, if the children transfer the Opco shares into a holding company, the children's ACB for section 84.1 purposes would be reduced from $6,000,000 to nil because of the capital gain realized by Bob, a non-arm's length party. As a result, they would be deemed to receive a taxable dividend on the $6,000,000 ultimately paid to them to fund payments under the promissory note, and pay tax thereon of $2,718,000. Therefore, $2,718,000 more tax would be paid compared to a sale by Bob of the company directly to a third party.[24]
- Alternatively, to personally fund the purchase, and without transferring Opco to a holding company, the children would need to receive net after-tax distributions from Opco of $6,000,000 over time. Assuming additional salaries were paid to the children, ignoring payroll taxes, approximately $11,208,668 would need to be earned by the children from the company.[25] Taxes paid are 53.53% or $5,208,668. This significantly exceeds the $8,163,265 that the company would need to have earned to fund the purchase under the current rules.

Examples 3 and 4 demonstrate the typical situation whereby (i) the current rules somewhat favour a sale of a corporate business to an arm's length third party rather than to family members, and (ii) the proposed rules would make this tax incentive significantly larger. Without relief, many families may find it difficult to rationalize a transfer of the family business between family members rather than positioning their business for sale to an arm's length purchaser. Particularly where the business derives a large proportion of its value from capital property that has accrued gains, including operating businesses that have developed goodwill and other capital intensive businesses involving real estate ownership, the proposed changes to section 84.1 may discourage a related-party transfer where the inherent capital gains will either become effectively fully taxable as dividends or will be double taxed as a consequence of a second tax on the future disposition of assets by the corporation.

---

[24] Bob would be taxable on his capital gain, regardless of whether he sells to an arm's length person or his children. To the extent Bob claimed the LCGE on the sale to an arm's length party, the additional tax would be reduced by $223,500 to $2,494,500.

[25] Integration of general corporate business income in Ontario is not quite perfect, so assuming no changes in future tax rates, Opco would need to earn slightly more than this, so that the after-corporate-and-personal tax cash flow of the children would be comparable.

c) Other Technical Concerns

Example 5 – Inappropriate "double counting" of previous gains

The proposed changes to section 84.1 would apply to shares in respect of which a gain has been realized on a previous disposition (of that share or a share for which the share was substituted) by the taxpayer or a non-arm's length person. The proposed wording does not, however, take into account that previous losses might also have been realized (including potentially "suspended" losses for which no tax benefit has yet been recognized by the non-arm's length person).

Assume Y incorporates Opco together with an unrelated person, P. Y and P each subscribe for 50% of the Opco common shares for $100,000. Y later sells his Opco common shares to his sister, Z at their fair market value of $500,000 and realizes a $400,000 capital gain. Z later sells the shares to her daughter K for their fair market value at that time of $400,000, realizing a capital loss of $100,000. K subsequently sells the shares to her brother L for their fair market value at that time of $500,000, realizing a capital gain of $100,000. Finally, L purchases the shares of P for their fair market value of $500,000. At this time, L's shares have a total fair market value and ACB of $1,000,000, but have total PUC of only $200,000.

The modified ACB of L's shares, under the proposed changes to section 84.1, would be $500,000, as a result of the reduction in respect of the previously recognized capital gains of Y and K. Accordingly, if L transfers his Opco shares to a wholly-owned Holdco, L will only be entitled to create PUC (or receive non-taxable "boot") totaling $500,000, even though the total of the capital invested by non-arm's length persons plus the ACB referable to shares that had never previously been owned by a non-arm's length person equals $600,000. In effect, the failure to take into account the capital loss realized by Z appears to inappropriately limit the modified ACB of L's shares for purposes of section 84.1.

Accordingly, we recommend that the proposed amendment to subparagraph 84.1(2)(a.1)(ii) be modified to use the amount, if any, equal to the sum of all amounts determined under subparagraph 40(1)(a)(i) less all amounts determined under subparagraph 40(1)(b)(i).

Example 6 – Administrative difficulties in determining ACB under proposed section 84.1

i) Lack of Available Information

The proposed amendment to section 84.1 will make tracking a taxpayer's modified ACB for purposes of section 84.1 administratively very difficult and in some cases impossible. Under the existing rules, a taxpayer only needs to know how much they paid to acquire their shares. In some cases where they purchased the shares from a non-arm's length party they need to know whether the non-arm's length party used the LCGE or if the shares had an accrued gain on V-Day.

Under the proposed changes to section 84.1, any time a share is acquired, all previous transactions by a non-arm's length party that resulted in a capital gain need to be identified, and related information determined and maintained, by the purchaser to properly calculate the modified ACB. This is expected to greatly increase the number of circumstances where this information is required.

We are concerned that in many cases, the information needed to perform the modified ACB calculation may be unobtainable. For example, assume a daughter purchased shares from her father in 1996. His tax returns for that year may have been destroyed many years ago, as there may have been no other reason to keep them after 2003. Without her father's tax returns, the daughter will be unable to calculate her modified ACB. Even if tax returns have been maintained, non-arm's length parties do not have a right to access each other's tax returns (and the proposed changes to section 84.1 will apply where parties were non-arm's length at the time of a disposition, even if at a later date, when ACB must be determined under section 84.1, they are no longer non-arm's length, for example following separation or divorce).

If the CRA maintained detailed records, the daughter may be able to ask her father (if he is still alive) to contact the CRA to obtain information on any capital gains he reported in 1996. However, it is our understanding that the CRA does not track detailed information on capital gains. Rather, the CRA's system only records the gross amount of capital gains corresponding to certain line numbers on the return, but not the specific shares on which those gains occurred. So, if the father requested information from the CRA to determine what gain he reported in 1996 on the private company share sale, in many circumstances the CRA would be unable to provide it.[26]

While prospectively, taxpayers can be advised to obtain and keep records regarding non-arm's length gains realized, in situations involving "factual arm's length" transactions between related parties that are deemed to be non-arm's length (for example, adversarial family business "split ups", etc.) it nonetheless may be impossible for a taxpayer to obtain, or verify, information regarding gains realized by counterparties to the transactions. Information regarding historical transactions (including whether a transaction occurred, how a transaction was characterized for tax purposes, and amounts reported) may be unrecoverable.

For these reasons, the Joint Committee is concerned that it may not be possible to report income with certainty where section 84.1 applies to ACB arising from previous transactions. **Regardless, the Joint Committee recommends that existing non-arm's length ACB not subject to the current rules in section 84.1 be grandfathered because the information necessary to comply with the new rules may not be available, and under current law there would have been no reason to maintain that information.**

[26] For example, if the father sold his shares of the private company (and did not claim the LCGE because they were not qualified small business corporation shares) and also sold shares of a number of public companies in the year, the CRA likely will not have the detail required to determine the amount of capital gain (if any) reported with respect to the private company shares. In this situation neither the daughter nor the CRA would be able to calculate her modified ACB under proposed section 84.1.

ii) Mechanics of Modified ACB Calculation

The calculation of modified ACB under proposed section 84.1 where gains arose on previous dispositions by a non-arm's length party is unclear under many fact patterns.
Example 1 under Clause 20 of the Explanatory Notes involves a simple scenario using a single share of Opco that is sold between non-arm's length parties and then eventually to Xco, an arm's length party, before ultimately being sold to B an individual who is non-arm's length with the previous Opco shareholders. In this scenario, using a single share, the calculation of modified ACB under proposed section 84.1 is clear.

However, if we instead consider a slightly more complex (but common) fact pattern, if Xco already owns a share of Opco when it acquires the Opco share from M, the calculation of the modified ACB under proposed section 84.1 is not clear. When B buys a share from Xco, there are a number of different ways to calculate his modified ACB under proposed section 84.1. He could assume the share he acquired was the original share owned by Xco, such that his ACB is not modified by proposed section 84.1 and would be the full amount of $600,000 he paid Xco for the share. Alternatively, the CRA might assume the share he acquired is the share previously owned by M, such that his modified ACB is the $160,000 calculated in the Explanatory Notes. Finally, perhaps an "averaging" calculation is required so that his modified ACB is somewhere between $160,000 and $600,000.

If we assume an even more complicated set of historic transactions where there are various share exchanges, amalgamations or other transactions during the time the Opco shares are owned by Xco, the calculation of modified ACB under proposed section 84.1 becomes even less clear.

Similar ACB calculation uncertainties can arise even where an arm's length party is not involved in the historical ownership stream. For example, assume that G owns 100 common shares of Opco. The share capital of Opco is reorganized and G exchanges his/her common shares for 100 new Class A common shares and 1,000 new Class B, fixed value preferred shares of Opco, realizing a capital gain on his 100 common shares. Subsequently, G subscribes for 1,000 additional Class B preferred shares. If G later sells 100 Class B preferred shares to his/her sister H, without realizing a gain on those Class B shares, it is not clear how to determine what portion, if any, of the previous gain realized by G is considered to "relate" to these Class B shares.

In this connection, we observe that the current version of subparagraph 84.1(2)(b)(ii) allows the taxpayer the opportunity to "establish the amount in respect of which a deduction under section 110.6 was claimed", and we understand that the CRA has previously allowed taxpayers to specifically identify a tracking of shares in this context (see, for example, Technical Interpretation 2000-0031395 dated July 25, 2000). It seems to us that the ability to do so in a broader set of circumstances will be needed going forward.

It is unclear to us why the modified ACB rules in section 84.1 need to be amended to apply to shares acquired from arm's length parties where they may have been previously owned by a non-arm's length party. This proposal would seem to add additional unnecessary complexity and practical difficulties.

Furthermore, it seems that this aspect of the rule may be a "trap for the unwary". In many cases, where a corporation controlled by an individual acquires shares from the arm's length person, section 84.1 will not apply notwithstanding that the purchaser is a corporation controlled by an individual who is related to an individual who had previously sold the shares at a gain to the arm's length seller. The extended rule will come into play only where an individual acquires the shares from the arm's length person, and the individual may not recognize the potential application of section 84.1 could have been avoided by using a corporation to make the acquisition.

To the extent that the government is concerned that taxpayers will attempt to avoid section 84.1 by temporarily selling shares to an arm's length "facilitator", the Joint Committee believes that existing jurisprudence concerning factual non-arm's length status (and with the GAAR as a further fall-back) should be a sufficient remedy. Alternatively, the government might consider a bright-line test or safe-harbour provision. For example, any previous non-arm's length transactions might cease to be relevant where the particular shares (or substituted shares) are held only by arm's length persons for a specific period, such as 36 months.[27]

d) Accommodating "genuine" related-party business transfers

In Budget 2017, as well as in the Consultation Paper, the government indicated that it would consider whether features of the current income tax system have an inappropriate, adverse impact on genuine business transactions involving family members. We have noted above our concern that the current system imposes greater tax on related-party business transfers with respect to use of the LCGE; the proposed change to section 84.1 would exacerbate this existing disadvantage. The Joint Committee appreciates that the Consultation Paper recognizes that the government is interested in an approach that could accommodate intergenerational transfers, but it appears that it intends to move forward immediately with such adverse changes without at the same time proposing concrete measures for consideration, with the same immediate effective application, to alleviate the issue. Along with the adverse results that may arise in a post-mortem context, these are among the key reasons why we believe it is inappropriate to move forward with changes to section 84.1 that will be applied immediately (and, in many cases, in a manner inconsistent with legitimate expectations), and that instead implementation of these changes should be deferred until companion relieving measures are determined.

In our view, in many situations, a transfer of a business among family members should be recognized as a "genuine transfer" and subject to the same tax treatment as that provided for a sale to an arm's length purchaser (rather than as a "tax avoidance transaction"). In this regard,

---

[27] Three years is used, for example, in subsection 69(11).

the Consultation Paper suggests that the hallmarks of a genuine transfer of a business to a new owner would generally include:

- the vendor ceasing on the transfer to have factual and legal control of the transferred business;
- the intent of the new owner to continue the business as a going concern long after its purchase;
- the vendor not having any financial interest in the transferred business; and
- the vendor not participating in the management and operations of the business."

Although we recognize the government's concern with identifying and distinguishing transactions that amount to improper surplus stripping from those that do not, in the experience of the members of the Joint Committee the identified hallmarks are too narrow and are not representative of what typically occurs in many arm's length sale transactions involving private corporations. A vendor does not always sell a controlling interest in the corporation, and so these "hallmarks" would be simply inapplicable in any situation where one family member would like to introduce additional family members into the business or recognize their historical and/or expected future contributions to the business with an equity interest.

Even where a controlling (or entire) interest in a corporate business is sold to an arm's length purchaser, it is not uncommon for the vendor to have an ongoing "financial interest" (whether in the form of a minority interest, an "earnout" arrangement designed to address potential disagreements as to the current fair value of the business, secured or unsecured "vendor take back" financing, etc.) or management role (whether through a continuing executive or temporary consultant function, etc., intended to support the business value inherent in the sale price, for example) in the business. Accordingly, the outlined criteria would represent a very high standard of "genuineness" that we anticipate would be very difficult for families to meet in practice, in connection with typical (and "genuine") *inter-vivos* business transfers among related parties.

In contrast, though, we note that the identified hallmarks would be satisfied where the transfer of private corporation shares is as a result of the death of the shareholder. It is difficult to envision a more certain indicator of the "genuineness" of a transfer to a new owner. **In our view, this point further supports our recommendation that the proposed changes to section 84.1 not apply in respect of shares acquired by virtue of the death of a shareholder.**

We recognize the challenges in delineating non-arm's length transactions involving the transfer of corporate shares that represent "genuine transfers to a new owner", which are presumably worthy of relief, and those that represent "tax avoidance" transactions, which are not. One of our recommendations is that there should be a full review of the tax rules that apply to private corporations and their shareholders. The difficulty in establishing rules for intergenerational transfers in the context of already complicated provisions is another reason for undertaking that review.

e) Possible alternative measures to avoid a "double tax" as a result of the application of proposed section 84.1

As noted in the various examples above, the application of proposed section 84.1 can result in significant double tax. The Consultation Paper readily acknowledges this fact, but suggests that any double tax that may arise is consistent with "discouraging taxpayers from entering schemes that seek to avoid section 84.1." With respect, there are many circumstances in which the amended section 84.1 would apply notwithstanding that there is no attempt to surplus strip. The Joint Committee believes that the legislation should not be drafted in a manner that assumes that any transaction (or, more accurately, "series of transactions" in a non-technical sense) in which an individual taxpayer realizes a capital gain on a sale of private corporation shares, where there is a subsequent non-arm's length transfer of the share (or a substituted share) to another corporation, involves a *de facto* "scheme" to attempt inappropriate surplus stripping. Many taxpayers may undertake transactions "inadvertently", or have undertaken transactions historically in compliance with section 84.1, as it then existed, and CRA administrative practice. Even today, more than 30 years after the introduction of existing section 84.1, taxpayers routinely fall into the "trap" of this section inadvertently (through poor, or simply lack of proper, tax advice).[28] Given a significant number of errors occur under the current version of section 84.1 , which are narrower and more readily understood[29] in comparison to the proposed rules, we are concerned that the number of errors made by taxpayers and their advisors will only increase. In this connection, we are concerned that a rule which imposes double tax as the "default" result under an expanded section 84.1 is simply unfair to taxpayers and a disproportionate remedy to counter the perceived mischief.

There are a number of possible alternatives that could be considered. Providing exceptions for bona fide business transfers (including possibly a *de minimis* exception) would be a helpful start. Measures such as those noted above, regarding alternatives in respect of gains deemed to be realized on death[30], or post-mortem planning for Estates, also would be helpful. In addition, the Joint Committee believes certain aspects of the following would be considered appropriate.

i) Relief for Income Tax Paid

As tax will have been paid by the vendor on the capital gain from the disposition of shares, it would be fair to recognize that tax by increasing the modified ACB under proposed section 84.1 proportionally so that double tax does not result.

One example of an approach might be as follows. Assume a sale of shares by a non-arm's length person results in a $100,000 capital gain. Recognition of the tax paid could be made by comparing the rate of tax paid on capital gains to the rate of tax that would have been paid on

[28] And although we have no statistics, we suspect that it is primarily taxpayers with smaller-value businesses that are so affected, rather than more "wealthy" Canadians.
[29] Because of the limited inquiry to pre-1972 gains and LCGE exempt gains.
[30] These alternatives might also be appropriate alternative approaches to consider more generally in connection with *inter-vivos* transfers.

an equivalent non-eligible dividend and increasing modified ACB in proposed 84.1 for that amount. The adjustment would be calculated by taking the rate on capital gains divided by the rate on non-eligible dividends multiplied by the gross capital gain. For example, using the tax rates provided in the Consultation Paper for an individual in PEI paying tax at the top marginal rate, the effective tax rate on capital gains is 25.69% and on non-eligible dividends is 43.87%. The suggested increase to the modified ACB on a $100,000 capital gain of the PEI individual would be 25.69/43.87 x $100,000 = $58,559.38. For purposes of proposed section 84.1, then, the modified ACB to the individual purchaser would become $58,559.38 rather than nil.

If the purchaser in the above example transferred their shares to a holding company, they could receive boot equal to $58,559.38 without triggering a deemed dividend and, if they receive the remaining share value as boot, they would continue to be deemed to receive a taxable dividend of $100,000 - $58,559.38 = $41,440.62 on which they would incur tax of $41,440.62 x 43.87% = $18,180 (assuming a non-eligible dividend). The total tax paid by the two parties on the $100,000 "distributed" from the corporation is $25,690 + $18,180 = $43,870, which is the same as if the $100,000 had been received directly as a non-eligible dividend. The end result is that dividend tax rates would apply but double tax would be avoided.

While this approach would reduce the potential cost of double taxation, admittedly, there are challenges with it. It would be complicated. Moreover, as discussed above, not all non-arm's length individuals may be prepared to share the relevant information. Both individuals may not be subject to the highest marginal rate, although in the interests of simplicity an assumption could be made that they are. In any event, the Joint Committee believes there should be some relief from double tax.

iii) Relief for "Safe Income"

As discussed elsewhere in this submission, we believe that one of the key issues to be considered is how "surplus" should be defined for purposes of the surplus stripping provisions. The rules are drafted on the basis that the entire accrued gain on a share should be taxed as a dividend, even where the gain is partly attributable to underlying accrued capital gains or goodwill gains within the corporation.

Accordingly, another possibility in computing the modified ACB under section 84.1 would be to deduct only the portion of each previous related party gain (that would otherwise reduce the modified ACB under the proposed section 84.1) that represented the amount of "safe income" that would have been deemed to be a separate dividend under paragraph 55(5)(f) if the vendor in that previous transaction had been a corporation. This would give ACB recognition for purposes of section 84.1 to the extent that the underlying corporate value at that time represented accrued gains rather than accumulated after-tax earnings.

For example, if we assume the non-arm's length vendor realizes a capital gain of $100,000 on a previous sale and there was $60,000 of safe income (and $0 ACB) with respect to those shares, the amount of modified ACB would be $100,000 - $60,000 = $40,000. This would provide effective capital gains treatment for the portion of the purchase price that represents an increase in the value of the capital assets and a result that may be seen as more consistent with other provisions of our tax system (including the taxation of capital gains as and when they are realized).

We acknowledge that this suggestion will be complicated and will require safe income calculations. However, it too should be considered as a part of the more general review of the taxation of private corporations and their shareholders that we have recommended.

3. Comments regarding proposed section 246.1

Background

We appreciate that surplus stripping has long been a concern for the Department of Finance ("**Finance**") and the CRA, and recognize its tax policy basis. We recognize that this concern has been heightened in recent years given the significantly increased gap between dividend and capital gains tax rates for individuals. Over the years, this concern has led to a number of legislative attempts to prevent various forms of surplus stripping. Provisions such as section 84.1 have been targeted and specific. Others, particularly former subsection 247(1), have been expansive and broadly worded.

The Explanatory Notes provide that proposed section 246.1 is an anti-avoidance rule intended to prevent the distribution of corporate surplus that would otherwise be distributed as a taxable dividend to a Canadian-resident individual in such manner that no tax or a reduced amount of tax is paid by the individual. It is intended to apply in a non-arm's length context. The wording of the provision in many respects closely resembles that of former subsection 247(1). While subsection 247(1) was repealed almost thirty years ago, and thus is essentially historical at this point, the literature suggests that it created significant uncertainty, in particular regarding whether the wide, uncertain ambit of the provision meant that it inappropriately applied to legitimate commercial transactions.

The proposed rule deems a portion of an amount received or receivable (directly or indirectly) by a Canadian-resident individual as part of a transaction or series of transactions to be included in the individual's income as a taxable dividend if the following conditions are met:

1. the portion was received (directly or indirectly in any manner whatever) from a person with whom the individual was not dealing at arm's length;
2. as part of the transaction or series, there is a disposition of property or an increase or a reduction of the paid-up capital in the capital stock of shares of a corporation; and
3. one of the purposes of the transaction or series was to effect a significant reduction or disappearance of assets of a private corporation in a manner such that any part of tax otherwise payable by the individual, in consequence of any distribution of property, is avoided.

In addition, proposed subsection 246.1(3) provides that when subsection 246.1(1) causes a capital dividend to be re-characterized as a taxable dividend, the capital dividend account

("**CDA**") of the payer corporation is generally reduced by the untaxed portion of any taxable capital gains the corporation realized as part of the series of transactions before the capital dividend became payable.

The Explanatory Notes accompanying proposed section 246.1 state simply that, in general terms, the avoidance requirement "is to be considered" to have been satisfied with respect to any amount received if the amount of tax payable by the individual from the transaction or series is less than the amount of tax that the individual would have paid on the receipt of a like amount as a taxable dividend. Beyond this statement, however, the Explanatory Notes provide virtually no guidance on the application of the rule. Neither the Explanatory Notes nor the Consultation Paper provides any examples of the types of transactions targeted by section 246.1.

We are concerned that the broad words of the proposed rule and the lack of guidance regarding its application create very significant uncertainty regarding its scope, and that this extends to any number of transactions that do not constitute surplus stripping as that concept is generally understood. As noted, these same concerns were expressed about former subsection 247(1) when it was in existence. Proposed section 246.1 is framed as an anti-avoidance rule, but because of its broad wording and because its purpose test is linked to a broad range of possible events and not to an identifiable tax abuse, it is extremely difficult to identify with any confidence the circumstances in which it may or may not apply, including in the context of many common commercial transactions. We also are concerned about the effect of the application of the proposed rule in certain circumstances where its application is intended.

The discussion that follows begins with a review of our concerns with respect to the breadth and apparent ambiguity of the provision's wording and certain other technical matters. This is followed by examples describing a number of common transactions with a view to demonstrating the tremendous difficulty that we believe will be encountered in practice when taxpayers and the CRA seek to determine the appropriate application of this rule. These examples contain further observations on aspects of the rules and suggestions as to their improvement. We then summarize our recommendations with respect to proposed section 246.1.

We also have significant concerns with the immediate application of this provision, including its possible application to completed transactions that form part of a series of transactions that straddles the rule's effective date, and transitional issues will be discussed separately.

Concerns

This portion of the submission outlines our principal concerns related to the particular statutory wording of the proposed rule. Given the expansive nature of the statutory language, these same concerns could be expressed in a different way, and are not exhaustive of the circumstances in which the provision may be problematic. The following discussion is divided into paragraphs addressing in turn particular elements of the statutory language in the proposed rule. As a general comment, we are concerned that the breadth of the statutory language in many cases will make it difficult to conclude that interpretive advice provided in Explanatory Notes or CRA statements intended to clarify some of the issues considered below would be supportable on the words. It may instead reflect an accurate statement of policy intent rather than legislative effect, leaving taxpayers with a significant degree of uncertainty as to their exposure to risk under the Act in connection with objectively non-abusive commercial transactions. For this reason, we encourage Finance to give serious consideration to the need to address these issues in the statutory language itself, with Explanatory Notes clarifying but not substituting for such language.[31]

"**Amount/Portion**". The proposed rule applies to a portion of an "amount" that is received or receivable. The use of the word "amount" means that this is not limited to the receipt of cash, but could also include the receipt of corporate property in kind, and shares or a note issued by a purchaser.[32] One basic question raised by this approach is whether, where the rule applies, it is intended that the receipt of non-cash consideration (such as a promissory note) be deemed to be a dividend, or whether subsequent distributions (principal payments) on that property be deemed to be dividends. Arguably, based on the current wording, both the issuance of the note and subsequent repayment of the note could be recharacterized as a taxable dividend. This result would clearly be inappropriate, and we assume is not intended. If the receipt of payments on the property is to be treated as a distribution subject to the rule, double tax could easily arise. Consider the circumstance where a note is given as consideration for a disposition of shares giving rise to a capital gain. The transaction could give rise to both a capital gain on the exchange of the shares for the note and a deemed dividend on the subsequent repayment of the note, thereby effectively taxing the same amount twice. The Explanatory Notes suggest that "several amounts" may be captured by the rule and specifically refer to "cash received under a loan". The manner in which the rule is intended to apply to "multi-step" transactions such as this – of which there will be many – should be clarified.

In addition, the legislation applies to "a portion" of an amount received; however, there is no indication of what portion of the receipt the rules are applicable to. More guidance is required in the text of the provision on the meaning of a "portion of an amount received or receivable".

"**Received or receivable directly or indirectly, in any manner whatever**". In *Garron*,[33] the Federal Court of Appeal held that Parliament chose the words "directly or indirectly in any manner whatever" deliberately to capture every possible means by which wealth and income earning potential can move to a person (including, on the facts of the case, a shift in value to

[31] In this regard, we note that prior to May 23, 1985 former subsection 247(1) applied "if the Minister so directs". This administrative discretion permitted the delineation of the scope of the provision through external materials. We do not recommend that Ministerial discretion be added to the proposed rule as it undermines statutory certainty, but observe that this distinction is relevant to the manner in which the proposed rule should be drafted and can be interpreted.
[32] Under the provisions of the Act, amount is defined to include "money" but also "rights or things expressed in terms of the amount of money or the value in terms of money of the right or thing".
[33] *Garron Family Trust (Trustee of) v R*, 2010 FCA 309.

indirectly held shares). This language is extremely broad, and will make the test difficult to apply in practice when combined with the extremely broad purpose test in the rule. It also may run the risk of inappropriately encompassing legitimate commercial transactions (or, at the very least, it may require difficult covenants and indemnities to be negotiated and provided which are not now common in commercial practice or consistent with economically rational commercial action). The "directly or indirectly" test does not appropriately distinguish true arm's-length transactions from surplus stripping transactions. The "directly or indirectly in any manner whatever" aspect of the rule needs to be better circumscribed in the text of the provision to avoid the application of the rule, indirectly, to arm's length transactions.

"By an individual". The Explanatory Notes indicate that the amount receivable by an individual that could be subject to this new rule can be received indirectly through a trust. In many (or perhaps most) cases, though, the rule could apply to the trust itself, together with individual beneficiaries that receive a distribution from the trust, because the application of the rule is not limited to "individuals (other than a trust)". Subsection 248(28) would not appear to prevent double taxation, because different taxpayers are involved.

It is possible that the "purpose test" might prevent the application of the rule to a trust where the trust itself would not have paid tax in any event, as a result of a deduction under subsection 104(6) where the amount was paid or made payable to a beneficiary. However, if the trust does not make the amount payable to a beneficiary in the year of receipt (there are a range of reasons for doing this, such as utilizing capital losses at the trust or in the case of a capital dividend receipt), this would be less clear. If the rule is to apply to the individual beneficiary at the time of a subsequent distribution from the trust, double taxation will result where the rule has also applied to the trust itself. If the rule is to apply to the beneficiary in the year of receipt by the trust because the individual is to be considered to have received the amount "indirectly", it is not clear how the amount would be allocated among beneficiaries of a discretionary trust (a question that would be further complicated if the trust's beneficiaries include corporations). If the rule is intended to apply to the trust, it similarly would be unclear what portion of the amount should, as a policy matter, be subject to the rule if the trust is discretionary and includes corporate beneficiaries.

If the rule is applied to an individual beneficiary who receives an amount from a trust as a distribution of a portion of an amount received by the trust that is a capital dividend, the trust should be deemed not to have received the capital dividend, to the extent of that portion. Otherwise, certain "stop-loss" rules (such as subsection 112(3.2)) could subsequently apply inappropriately to the trust. A similar rule should apply in respect of amounts received by an individual "through" a partnership.

"Deemed to be included in computing the individual's income". It is not clear whether the wording of subsection 246.1(1) deeming the portion of the amount to be "included in computing the individual's income for the year as a taxable dividend received" will have the appropriate effect. In order to properly reflect the "conversion" of the distribution to a taxable dividend from the relevant private corporation, the wording should also provide that the dividend is deemed to be received “from a corporation resident in Canada”. This will ensure that the appropriate “gross-up” provisions of section 82 and dividend tax credit provisions of section 121 apply to the amount. Likewise, the amount should be deemed to be a taxable dividend paid by the distributing corporation so that symmetrical treatment is achieved for both taxpayers.

“**Non-arm’s length**”. The inclusion of the non-arm’s length requirement in the proposed provisions (not found in former subsection 247(1)) is a clear improvement on that rule. Without it the provision could apply indiscriminately to most commercial transactions. However, we are concerned that the concept of non-arm’s length, in itself, is not a sufficient basis to distinguish inappropriate surplus stripping from legitimate commerce in this context. There are many transactions between deemed non-arm’s length parties that are purely commercial transactions occurring on terms that would apply to arm's length transactions as well. The non-arm's length status of the transaction is incidental. In our view these transactions should not be captured by the proposed rule. These include, for example, transactions among family members that are true business partners, and transactions where a minority shareholder, otherwise arm’s length from a particular corporation, has chosen to hold the share investment in the corporation through a wholly-owned holding company.

Persons who are factually dealing in an arm’s length manner are deemed not to deal at arm’s length where they are related, or may be deemed related due to a paragraph 251(5)(b) right. We encourage Finance to reconsider whether commercially legitimate transactions occurring between (some) related persons should be excluded from the scope of the proposed rule. In addition, in our view, a transaction with an otherwise arm’s length person should not be subject to the proposed rule where the relevant non-arm's length relationship arises solely because of a right described in paragraph 251(5)(b) or the application of subsection 251(3).

We believe it is the intention of proposed paragraph 246.1(2)(b) that the non-arm's length status of the parties be tested at the time that the amount in question is received so that, for example, the receipt of amounts from a corporation operated and controlled by a *bona fide* arm's length party is not potentially subject to the proposed rule because the recipient had previously sold shares of the corporation to that arm's length person. The Explanatory Notes can be read as implying that this interpretation is correct, but uncertainty remains. At some level, the assets of a corporation that is sold, either those on hand at the time of the sale or cash generated from operations or future sales, in many cases will be used to fund the purchase price paid by the purchaser. If the basic premise is that individual shareholders may realize their investment on a third-party sale in the form of a capital gain (which was recognized in the context of former subsection 247(1)), the fact that the purchaser may directly or indirectly use funds sourced from Opco should not alter this conclusion. We recommend that proposed paragraph 246.1(2)(b) be amended to make explicit that the non-arm's length status is measured "at that time". In our view, this would not detract from the application of the rule to non-arm's length components of a series of transactions that included an arm's length component, but it would appropriately distinguish the two, and would avoid the need to request CRA rulings in respect of what would today be considered “normal” sale transactions.

We are of the view that the “non-arm’s length” standard also should apply to the provisions of proposed subparagraphs 246.1(2)(c)(i) and (ii) relating to dispositions of property and changes in paid-up capital. As currently drafted and as illustrated by the examples below, it appears possible for arm’s length transactions to be the basis for the application of the proposed rule, which seems unlikely to be an intended result. This clarification also would be of general assistance in connection with arm's length sales, discussed in the preceding paragraph.

“**Reduction or disappearance of assets**”. In order for the proposed provision to apply, one of the purposes of the transaction or series must be to effect a significant “reduction or disappearance” of assets. This is unusual and awkward wording. The Explanatory Notes indicate that section 246.1 is “intended to prevent the distribution of corporate surplus (in general, unrealized corporate value less liabilities) to an individual”. It is not clear how “unrealized corporate value” can be distributed. Presumably the concern is that realized corporate surplus is being distributed in a transaction that takes advantage of tax attributes (in particular CDA) that arise on the realization of a capital gain related to "unrealized" corporate value. A number of extremely important interpretive ambiguities arise from this open-ended wording.

- Is “bad” surplus intended to be limited to retained earnings (or something similar to “safe income”), or is it intended to include all net asset value (in effect, applying the rule to the capitalized value of future earnings)?
- The language of the provision suggests that assets for this purpose are to be determined on some type of consolidated or look-through approach but there is no guidance on the manner in which this is to be done. Further clarification is needed regarding when a private corporation holds an interest in assets "directly or indirectly".
- There is no discussion of the meaning of "reduction or disappearance of assets". Does the test look at specific identifiable assets held by a private corporation and seek to determine whether they have been reduced or disappeared (an "asset tracing test")? Alternatively, does the test look to whether the corporation’s gross assets or aggregate net asset value has been reduced (a "value test")? If so, which one? For example, a direct transfer of corporate cash from the target to the non-arm’s length shareholder as a return of capital distribution appears to be caught by either an asset tracing test or a value test, but the purchase of a business asset from the shareholder for fair market value consideration could be caught under an asset tracing test but not a value test. Beyond this, there are obviously many conceivable ways as part of normal commerce that identifiable assets, or net asset value, of a company may be changed or reduced or may “disappear” from the corporation, and without meaningful statutory guidance the interpretation of the intended scope of this wording will be highly uncertain.
- The purpose of the phrase "and in consequence of any distribution of property of a corporation" is not clear to us. We believe that it is anchoring the rule to a transaction that constitutes a distribution of property by the corporation, but the syntax of the provision makes certainty as to its intended effect unclear.

"**Avoided**". There are numerous ambiguities with the use of the word "avoided". Does it apply only to an absolute reduction of tax, or might it also apply to tax deferral. The definition of "tax benefit" for purposes of the GAAR uses the phrase "reduction, avoidance or deferral of tax", suggesting that tax "avoided" should be considered to mean something different than tax "reduced" or "deferred", but it is not clear. We also have significant concern with the statement in the Explanatory Notes noted above that an avoidance will occur for this purpose, almost by definition, if the tax actually paid is less than the tax that would have been paid if the item in question had been taxed at the dividend tax rate. In *Copthorne*,[34] the Supreme Court of Canada reconfirmed the longstanding core principle of Canadian tax that "taxpayers are entitled to select courses of action or enter into transactions that will minimize their tax liability". In any tax system that prefers the realization of a capital gain (or non-taxable receipts such as the repayment of a shareholder loan) to the receipt of a dividend, Parliament must be taken to understand that taxpayers will deliberately structure transactions to provide for a beneficial result. Accordingly, the minimization of tax, in itself, should not be the only guiding benchmark in the application of the proposed rule. As with the GAAR, the analysis should further consider whether the tax minimization is appropriate or not, and the statutory text should provide taxpayers with clear guidance in this regard.

Related to this point, the avoidance concept seems to be based on the proposition that the hypothetical tax otherwise payable is the amount that would arise on payment of a dividend. There are, however, other, entirely legitimate ways in which property of a corporation can be "distributed". Although in some cases, a distribution could be by way of dividend, the term is typically used to cover any amount received by a shareholder *qua* shareholder. For example, subsection 84(2) uses "distribution" language in a broad sense, but does not contemplate that the repayment of a loan would constitute a "distribution". A distribution under subsection 84(2), though, clearly contemplates that paid-up capital can be received first, and nothing in that subsection precludes the deemed dividend being treated as a capital dividend. Subsection 88(2) also contemplates the "distribution" of property in the course of a winding-up in a manner that does not necessarily involve an actual dividend, and again clearly provides that paid-up capital is considered to be received first, and then CDA (including CDA created from winding-up gains triggered on previously "unrealized corporate value"). These two circumstances represent possible situations in which a "distribution" might occur where, under the scheme of the Act, there is no intention that it be treated fully as a taxable dividend. This suggests that determining whether tax (as a specific amount) that would be payable in consequence of "any distribution of property" has been avoided is not straight forward. What is the appropriate comparative amount of tax against which the individual's actual tax payable should be measured? In many cases, it may be far from clear. Given that our tax system does not require (or permit – see for example subsection 15(1)) corporate distributions in all forms and situations to be taxed as taxable dividends, we question the basis for concluding that a taxable dividend distribution will in all cases be the normative comparator.

[34] *Copthorne Holdings Ltd v R*, 2011 SCC 63.

In addition, the inclusion of the series concept in the purpose test might lead to the inappropriate application of the rule. In *Copthorne*, the Supreme Court of Canada held that the creation of a tax-attribute (paid-up capital) may be part of the same series as the use of that attribute, even if there are no plans to use the attribute at the time the attribute is created. On this basis, although we do not believe it is the correct interpretation, it could be argued that the creation of CDA or paid-up capital will be part of the same series as its use, even if the latter occurs many years in the future and was not planned when the attribute arose.

Examples

The examples that follow highlight the uncertainty or potential inappropriate results relating to the application of the proposed rule. The examples range from circumstances in which in our view the rule would not be intended to apply to circumstances in which the statutory intent is not clear. These examples are not a complete list of all circumstances where section 246.1 may apply in situations that, in our view, should not be subject to the rules, but rather are intended to illustrate that greater clarity is required as to when the rule is intended to apply. We would be happy to engage further with Finance to discuss examples of other situations where the rules appear to apply in unintended situations.

The examples are based on a common set of assumed facts. A number of years ago, Brother and Sister incorporated an operating corporation in the technology sector ("**Opco**"). Both Brother and Sister are over 24 years of age, have significant education and training in their field, and participate actively in the conduct of the business on a regular basis. Brother and Sister are related (under the Act), but are true business partners in every sense. Brother and Sister are residents of the Province of Ontario and subject to tax at the highest marginal rate.

On incorporation, each of Brother and Sister subscribed for 1,000,000 common shares of Opco for $250,000. Each of Brother and Sister also loaned $250,000 to Opco. Opco has been very successful and has earned $3 million after tax, which is invested by Opco in cash and marketable securities in order to support the business, weather possible downturns, and provide immediate capital in the event of a business opportunity. The shares are now worth $10 million ($7.5 million attributable to business assets and $3 million attributable to the cash and marketable securities, less shareholder loans of $500,000). It is assumed that Opco has "safe income" of $3 million, no RDTOH and a CDA of $200,000 (which arose from the non-taxable portion of capital gains on arm's length sales of marketable securities).

1. Basic Corporate Distributions

Example 1A

Assume that Brother and Sister require cash personally and for this purpose cause Opco to sell certain of its marketable securities for after-tax cash proceeds of $1 million, generating an additional $100,000 of CDA. Opco would like to distribute the after-tax proceeds to Brother and Sister as follows: (i) $250,000 to each of them as a repayment of their shareholder loans, (ii) $150,000 to each of them as a capital dividend, and (iii) $100,000 to each of them as a return of paid-up capital. Viewed subjectively or objectively, the facts are clear in this situation that Brother and Sister specifically intend to receive the payments on a tax-free basis.

On a literal reading of proposed section 246.1, it could apply to treat all three forms of distribution as a taxable dividend, including the paid-up capital return and the shareholder loan repayments which represent a return of after-tax capital contributed by Brother and Sister.

On the words of the test outlined in subsection 246.1(2), amounts were received from a non-arm's length person (Opco) as part of the series of transactions in which there was a disposition of property (the marketable securities by Opco and cash to make the distribution) and a reduction of the paid-up capital of the shares of a corporation (Opco). Also, as part of the series, there was a reduction of the assets of Opco and neither Brother nor Sister will pay any tax on the distributions. According to the Explanatory Notes, the avoidance test in paragraph 246.1(2)(d) would be presumed to be met in these circumstances.

In addition, under proposed subsection 246.1(3), the CDA of Opco will be reduced by the non-taxable portion of any capital gains the corporation realized as part of the series of transactions and before the distributions. In this case the sale of marketable securities forms part of the series that includes the distributions. Proposed subsection 246.1(3) would therefore eliminate the $100,000 of CDA generated on the sale. Under the reasoning in *Copthorne*, it is also arguable that any transaction generating CDA would be included in a series of transactions that includes the use of such CDA. Although, as noted, we do not believe this would be the correct interpretation in this context, it is possible that the original $200,000 of CDA could then also be eliminated, even though it was not generated in contemplation of any specific distribution.

Because the CDA reduction is deemed to occur immediately before the distribution, the CDA balance would be nil at the time the dividend is paid and the election is made. Because a recharacterization of a capital dividend pursuant to subsection 246.1(1) is a one-sided adjustment for the recipient only, it appears that Part III tax would be applicable to Opco for electing to pay a capital dividend in excess of the CDA balance. To avoid such tax, the shareholders and the corporation (in this case at least) might agree to elect under subsection 184(3) to have the dividend deemed to be a (non-eligible) taxable dividend. Having done so, though, the conditions for the application of subsection 246.1(1) in respect of the (former) capital dividend would no longer be met, because "appropriate" tax would now be payable by Brother and Sister in respect of that portion of the distribution. **To avoid this circular result, we recommend that subsection 246.1(3) be modified to reduce the CDA balance only by the amount, if any, by which the non-taxable portion of gains previously added to the CDA as part of the series exceeds the capital dividends paid as part of the series.** Please see the table below for an illustrative calculation.

Calculation of CDA		Only current year capital gains included in the series	All prior year capital gains included in series (Copthorne)
Non-taxable portion of capital gains from prior years		200,000	200,000
Non-taxable portion of capital gains in current year		100,000	100,000
Capital dividends paid in prior years		-	-
CDA before the payment of capital dividend (and 246.1(3))		**300,000**	**300,000**
246.1(3) adjustment	(1)	(100,000)	(300,000)
CDA before the payment of capital dividend		**200,000**	**-**
Capital dividend paid by Opco		(300,000)	(300,000)
CDA balance going forward		**-**	**-**
"excess" subject to Part III tax at 60%		100,000	300,000

Notes

(1) Opco is paying a capital dividend that includes the payment of the portion of the CDA relating to capital gains realized in prior years. If a portion (say $100,000) of the CDA balance from prior years had previously been distributed as a capital dividend (prior to proposed section 246.1), and therefore a capital dividend of only $200,000 is paid as part of the "current" transactions, it appears that subsection 246.1(3) could still result in a reduction of $300,000 to the CDA balance, such that the CDA balance would become negative $100,000, because the "grind" to the CDA balance is proposed to be in respect of the full amount added to the account in respect of prior gains that form part of the series. It is not clear whether the reduction to the CDA balance is to be done as if it were a separate paragraph in the CDA definition, or whether it is to be treated as a reduction to the paragraph (a) portion of the definition (the "capital gains and losses" section), such that the negative $100,000 balance in the previous example would not by itself prevent the payment of a subsequent capital dividend in respect of amounts added to the account under other paragraphs of the definition.

We are not aware of any reason why the proposed rules should apply to such ordinary, legitimate transactions. It has been a clear principle since 1972 that shareholders can choose to receive a return of paid-up capital that is not included in income regardless of the amount of accumulated earnings (or, indeed, unrealized corporate value). Similarly, the addition of an amount to the CDA balance in respect of gains on arm's length dispositions of marketable securities held as capital property is intended to give effect to the integration principle which underlies the basic operation of the Act. It is not clear, though, on the words of the proposed rule that these considerations are relevant to its application. We include this example to highlight the uncertainty presented by the text of the proposed rules, and the difficulty that will be encountered applying them in practice as drafted and without any further guidance, even in the context of ordinary commercial transactions.

Example 1B
Assume that Sister has developed some technology having a fair market value of $1 million that Opco wishes to acquire. Sister's adjusted cost base in the technology is a nominal amount. Sister sells the technology to Opco in exchange for cash proceeds of $1 million; Sister realizes a capital gain of $1 million on the disposition.

The text of proposed section 246.1 could treat the proceeds of disposition received by Sister as a taxable dividend subject to tax of 45.3% if an asset tracing approach is taken. Further, it appears that the disposition would nonetheless be included in income as a capital gain subject to tax at a rate of 26.77% in Sister's hands, i.e., taxed twice.

For purposes of subsection 246.1(2), describing the circumstances in which subsection 246.1(1) applies, amounts were received from a non-arm's length person (Opco), as part of a transaction in which there was a disposition of property (the technology and cash). As part of the transaction there was a reduction of assets of Opco (i.e., cash) and Sister would otherwise pay tax on the receipt that is less than the tax that would be paid if the receipt were taxed as a dividend. According to the Explanatory Notes, the avoidance test would be presumed to be met in these circumstances.

Again, we expect that the proposed rules are not intended to apply in this situation but uncertainty exists because of how broadly subsection 246.1(2) has been drafted.

2. Arm's-length Sale of Opco
Example 2
Brother and Sister receive an unsolicited offer from a third-party (Buyer) to sell the Opco shares for a cash purchase price of $10 million, and the following steps occur.

- Buyer incorporates a new Canadian corporation ("**Acquireco**") to effect the acquisition and capitalizes Acquireco with $10.5 million in cash in exchange for newly-issued common shares.
- Acquireco lends $500,000 to Opco. Opco uses the loan proceeds to repay the shareholder loans of $250,000 owing to each of Brother and Sister.
- Brother and Sister incorporate a new Canadian corporation ("**Holdco**") and transfer their Opco shares to Holdco for common share consideration. The parties file an election under section 85 for each share transfer. The paid-up capital and adjusted cost base of the Holdco shares issued to each of Brother and Sister will be $250,000 (or $500,000 in total).
- Opco increases the stated capital (and the paid-up capital) of its common shares by $3 million, being an amount equal to its safe income. The adjusted cost base of the Opco shares to Holdco is increased by $3 million pursuant to paragraph 53(1)(b), so that the aggregate adjusted cost base of the Opco shares to Holdco prior to the sale is $3.5 million.
- Acquireco purchases the Opco shares from Holdco, and satisfies the purchase price with the Acquireco cash.

Holdco realizes a capital gain of $6.5 million. Following the sale, Holdco increases the stated capital of its shares by $3.25 million, being the amount that added to its CDA on the sale of the Opco shares. Holdco subsequently increases the stated capital of its shares by an amount sufficient to recover the refundable tax payable on the capital gain realized on the sale of Opco shares by Holdco, and Brother and Sister are deemed to receive a corresponding taxable dividend. In the future, Brother and Sister will be able to receive the $3 million of safe income in the form of taxable dividends from Holdco.

In this example, Brother and Sister have received three amounts from a non-arm's length person (Opco or Holdco, as the case may be) in connection with the sale: the repayment of their shareholder loans, a capital dividend and a taxable dividend. Further the conditions in proposed paragraphs 246.1(2)(a), (b) and (c) will be satisfied, such that a determination of whether this provision applies rests on the purpose test in proposed paragraph 246.1(2)(d). The Explanatory Notes suggest that an individual is effectively presumed to have avoided tax if the tax payable on any amount receivable is less than the tax the individual would have to pay if the form of the amount received or receivable was instead a taxable dividend.

No tax would be payable by Brother and Sister on the repayment of the shareholder loans and the capital dividend, such that *prima facie*, proposed section 246.1 could apply to these amounts. This is the case even though the aggregate "proceeds" indirectly received by Brother and Sister from Acquireco will be subject to a higher effective tax rate, when the safe income is ultimately distributed, as compared to the tax that would have been payable on an outright sale of the Opco shares to Acquireco (see the comparison of Example (a) to Example (b) in the table below). This type of "safe income extraction" planning has been standard practice for years, and is specifically permitted under the subsection 55(2) regime. The application of proposed section 246.1 to the shareholder loan, paid-up capital return proceeds and capital dividend would effectively eliminate the benefit of safe income and in fact would result in Brother and Sister being subject to an overall effective tax rate on a capital gain realized on the sale of shares to an arm's length purchaser at rates in excess of dividend rates (see Example (c) below). This result is inappropriate and we believe it could not have been intended.

		Example 2(a)				Example 2(b)			Example 2(c)	
						RDTOH & CDA available			RDTOH available but 246.1 applies	
Sale of Opco Shares						Safe Income Structure			Safe Income Structure	
		Brother	**Sister**		**Holdco**	**Brother**	**Sister**	**Holdco**	**Brother**	**Sister**
		50%	50%			50%	50%		50%	50%
Proceeds of Disposition		5,000,000	5,000,000		10,000,000			10,000,000		
Adjusted Cost Base		250,000	250,000		3,500,000			3,500,000		
Capital Gain		**4,750,000**	**4,750,000**		**6,500,000**			**6,500,000**		
Taxes - permanent	26.77%	1,271,338	1,271,338	9.75%	633,750			633,750		
Taxes - refundable				15.33%	996,667			996,667		
After-tax cash available		**3,728,662**	**3,728,662**		**8,369,583**			**8,369,583**		
DISTRIBUTION OF CORPORATE PROCEEDS										
Dividends paid - capital					(3,250,000)	1,625,000	1,625,000	(3,250,000)	1,625,000	1,625,000
Dividends paid - taxable					(2,600,000)	1,300,000	1,300,000	(2,600,000)	1,300,000	1,300,000
Dividend refund				38.33%	996,667			996,667		
Personal tax on taxable dividend				45.30%		(588,900)	(588,900)		(1,325,025)	(1,325,025)
SUBTOTAL (Proceeds partially distributed)			**3,728,662**		**3,516,250**	**2,336,100**	**2,336,100**	**3,516,250**	**1,599,975**	**1,599,975**
Dividends paid - taxable					(3,016,250)	1,508,125	1,508,125	(3,016,250)	1,508,125	1,508,125
Return of capital for hard basis					(500,000)	250,000	250,000	(500,000)	250,000	250,000
Personal tax on dividends (and on return of capital and s/h loans in (c))				45.30%		(683,181)	(683,181)		(909,681)	(909,681)
AFTER-TAX CASH			**3,728,662**		**-**	**3,411,044**	**3,411,044**	**-**	**2,448,419**	**2,448,419**
Effective tax rate			25.43%			31.78%	31.78%		51.03%	51.03%

3. Transactions with Shareholders and/or Opco

Example 3

Assume that Brother needs money personally and proposes to have Opco pay a dividend or sell its business, but Sister, who holds the same class of Opco shares as Brother, does not wish to receive a dividend or sell the business.

There are a number of alternatives that Brother and Sister could pursue. For example, Opco could make a loan to Brother on market terms and conditions that Brother will repay within the time referred to in subsection 15(2.6). In this scenario, would proposed section 246.1 apply to the loan? What if, instead, Brother borrowed funds from a financial institution and Opco provided a guarantee?

In the alternative, Brother could dispose of his Opco shares through the following alternative transactions:

- Opco could purchase Brother's shares for cancellation, resulting in taxable dividend treatment for the portion of proceeds in excess of the pro-rata PUC. If, however, Opco needs to borrow funds to finance the purchase, Opco's ability to deduct interest will be limited to the extent that the principal of the debt exceeds the pro-rata share of paid-up capital and earnings of Opco.
- Brother could sell his Opco shares to Sister and realize a capital gain. Sister will not be able to access any funds of Opco to facilitate the purchase without paying tax at taxable dividend rates, as a result of the potential application of section 246.1 if she attempts to

receive a PUC distribution, and because section 84.1 (as it is proposed to be amended) would prevent her from converting the ACB in her shares into debt of a Holdco that could be paid out of tax-free dividends from Opco to Holdco). Therefore, Sister is unlikely to be willing to pay full arm's length "fair market value" for these shares. Notwithstanding, Brother will be deemed by subsection 69(1) to receive proceeds of disposition equal to that higher fair market value, such that the effective tax rate payable by Brother on the sale (that is, determined based on actual proceeds less actual taxes paid by Brother) would be inflated.

Consider Brother's position if he had previously transferred his shares to a Holdco (or simply acquired them through the Holdco originally when Opco was established) that, because of the tax concerns noted above or otherwise, Sister is unwilling to purchase directly as a means of acquiring the Opco shares. Sister still would be unwilling to acquire Opco shares directly from Holdco without paying substantially less than fair market value. Accordingly, the only realistic alternatives would be a purchase of Holdco's shares of Opco (i) for cancellation or (ii) by a SisterHoldco.

A purchase of shares for cancellation would appear to result in a deemed capital gain in Holdco, from the application of subsection 55(2) to the portion of the proceeds in excess of PUC and the safe income attributable to the shares, and Opco could have interest deductibility problems as noted above. A purchase of shares by SisterHoldco would result in a full capital gain in Holdco. In either case, if Brother subsequently receives a capital dividend from Holdco, section 246.1 could apply to treat it as a taxable dividend. If so, Brother's effective tax cost will exceed regular taxable dividend rates, even though he had no other way of structuring the transactions.

Applying subsection 55(2) and proposed section 246.1 to the same series of transactions seems to be fundamentally unfair, in that the former will convert dividends (in excess of safe income) into capital gains subject to corporate tax (such that gain treatment is "mandatory") and yet a shareholder is then prevented from "benefitting" from the resulting non-taxable portion of such gains, as a result of two separate anti-avoidance rules addressing the same facts and coming to opposite results. Alternatively, if section 246.1 does not apply, because Brother would not be considered to have met the purpose test, then arguably the same conclusion should apply if Brother simply incorporates a Holdco to facilitate his sale – he should not be penalized for not having the forethought to have set up a Holdco originally.

This is just one simple example of the variety of real-world situations that can arise between parties that are deemed to be non-arm's length but who in fact deal (or at least "transact") effectively at arm's length. Without relief, proposed section 246.1 and the proposed changes to section 84.1 will exacerbate the challenges that can arise currently as a result of rules such as section 69 that apply in respect of deemed non-arm's length persons.

4. Minority Investments

Example 4A

Assume that, instead of selling Opco, Brother and Sister decide to look for a minority partner to raise cash to pursue a large business opportunity, and to gain access to expertise in growing the business to the next level with the intention of eventually seeking a liquidity transaction (i.e. sale or IPO). Accordingly, Brother and Sister agree with a US private equity fund (the "**Fund**") that it will subscribe for 1,000,000 common shares (one-third of the shares) for $5 million. The parties decide to issue the same class of shares — it is recognized that paid-up capital will be averaged over the class but (as is common with many private equity investments) there is no intention at that time to return capital prior to a liquidity transaction. In any event, the Fund consists mostly of US tax-exempt entities that benefit from Article XXI of the Canada-US Income Tax Convention.

The funds from the subscription are used by Opco to engage in the business opportunity which significantly expands the business. Some years later, Opco has generated an additional $3 million which it would like to distribute to the shareholders because the funds are no longer needed to support a more mature business. The parties choose to return $3 million on a paid-up capital reduction, $1 million to each of the Fund, Brother and Sister. No dividend arises because the paid-up capital of the common shares is $5.5 million. Each of Brother and Sister realize a $750,000 capital gain.

The issue to be considered is whether the proposed rule might apply to Brother and Sister. These facts do not seem contrived or remarkable. However, an individual has received an amount from a non-arm's length person, on a disposition of property (Opco disposes of cash), and one of the purposes of the transaction is clearly to reduce Opco's assets on a non-taxable basis. Assuming, from example 1 above, that the provision is not intended to apply to all returns of capital, the additional question in this case is whether the prior averaging of paid-up capital in this situation should cause the rule to apply. The rule contemplates increases in paid-up capital, but offers no guidance on when such increases are acceptable or not. In this situation, the parties understood the effect of using the same class of shares, but did not at that time have any intention of returning capital (and note that the Fund's composition makes it basically indifferent to the receipt of cross-border dividends). If one simply uses the fact of the eventual result — that Brother and Sister obtained increased paid-up capital that later benefitted them — to cause the rule to apply with no more, the rule would seem to require that all shareholders would need to segregate paid-up capital in different classes of shares. Such a paradigm will be unworkable in practice in many cases, and unthought-of in others. The basic construct of the Act averages paid-up capital over a class of shares, and it would be a fundamental concern if proposed section 246.1 requires a deeper analysis into the many (sometimes tens or hundreds) transactions that have caused paid-up capital of a class of shares to be built up over time. Instead, we believe that relying on the case law which has considered the application of GAAR to potentially abusive paid-up capital transactions[35] is a more

[35] See, for example *1245989 Alberta Ltd v R*, 2017 TCC 51. The Tax Court of Canada found that artificially inflating the paid-up capital of a class of shares in order to benefit from averaging was an abuse of the subsection 89(1)

appropriate and sufficient benchmark to determine which paid-up capital shifting transactions ought to be sanctioned.

Example 4B

Assume, instead, that all of the limited partners of the Fund are Canadian resident individuals. Prior to the first reduction of capital, the Fund transfers the Opco shares to Fundcanholdco for common shares having a paid-up capital of $5 million (a section 85 election is filed and assume that section 84.1 does not apply to reduce the paid-up capital further). The Fund is concerned that a portion of its share of paid-up capital reductions (which in total could exceed approximately $1.83 million over time) might be taxed as a dividend even though Fund invested $5 million. The initial paid-up capital reduction is not an immediate concern, but future reductions (if any) could be.

The question to be addressed in this scenario is whether section 246.1 might apply to the Fund if it later receives returns of capital from Fundcanholdco that exceed $1.83 million. A number of issues are raised by this example. The Explanatory Notes suggest that an individual may receive an amount indirectly through a partnership, but no guidance is given on whether the arm's length test should be applied at the partnership level or the individual level. In addition, the Fund deals at arm's length with Opco and so the rule would not apply to payments received by it directly. However, the insertion of Fundcanholdco, at least raises the possibility of the application of the rule.

Perhaps the greatest concern in the present circumstances is whether the rule could apply to a purchaser, rather than (or in addition to) a vendor, in the context of a commercial transaction. Example 4A asks whether the paid-up capital shift should cause the rule to apply to Brother and Sister. In Example 4B, the question is whether it could apply to the Fund (and its partners).

In our view the rule should not apply in this case because the Fund invested capital and should be entitled to receive a return of $5 million without risk of tax. The transfer to Fundcanholdco is not subject to section 84.1 (the Fund has arm's length basis of $5 million and no non-arm's length person has previously recognized a capital gain on the shares). In addition, the Fund could have established Fundcanholdco at the outset to make the acquisition. If the paid-up capital shift involves a mischief, and we are not suggesting that it does on these facts, the consequences should be visited only on the vendors who benefitted from the increased paid-up capital. The return of $5 million to the Fund cannot be properly thought of as surplus stripping. If, instead, Finance believes that a purchaser such as the Fund could be subject to the rule, tremendous inefficiencies will result because Canadian resident individuals will be required to use a freshly capitalized holding company to purchase shares in many circumstances where it would not otherwise have been required.

---

definition of paid-up capital and section 84.1. This suggests that the GAAR is a sufficient tool to deal with inappropriate manipulations of paid-up capital (as opposed to averaging that would occur in an ordinary, legitimate commercial transaction).

Example 4C
The general facts are the same as in Example 4A (i.e., the Fund has non-resident partners), with the following exceptions: (i) Opco will make a distribution of $1 million; (ii) the Fund subscribes for a different class of shares; and (iii) Opco would also like to pay a portion of the distribution as a CDA dividend. Brother and Sister will receive a CDA dividend in addition to the reduction of capital, and the Fund will receive a higher reduction of paid-up capital.

This planning is typical and has been accepted by the CRA. It is worth emphasizing that CDA streaming is permissible in some circumstances under the Act.[36] However, one of the purposes of the series of transactions, which includes the issuance of shares of a different class to the Fund, is to permit Brother and Sister to receive a higher capital dividend and therefore to pay less tax. This example provides another illustration where traditionally accepted structuring may be inappropriately caught by the rule.

5. Other issues
We expect that there is a broad range of other possible concerns with proposed section 246.1, some of which have not been identified in the time available. Among these, the broad wording of section 246.1 calls into question the continued effectiveness of the system which permits the distribution of life insurance proceeds (in excess of tax basis) to shareholders on a tax-free basis using the CDA mechanism. As previously noted, the Explanatory Notes seem to suggest that any shareholder distribution is to be tested against a taxable dividend. Consequently, a deceased's estate may be deemed to have received a taxable dividend instead of a tax-free capital dividend that was funded from life insurance proceeds on a policy acquired by the company for that purpose. Also, if a shareholders' agreement is structured so that the surviving shareholder is to receive the insurance proceeds as a capital dividend and use those funds to purchase shares from the deceased's estate at FMV the shareholder may also be faced with a tax liability from the recharacterization under section 246.1. Presumably, this is not the provision's intention, but without a clear exception such situations could be attacked.

RECOMMENDATIONS

The wording of proposed section 246.1 is unclear and exceptionally broad, and the context of the Act and the Explanatory Notes offer no meaningful guidance on its intended application. We are concerned that there is no adequate basis on which to determine whether the proposed rule will apply in many circumstances where, in our view, its application would be unwarranted, including many cases that clearly have no element of surplus stripping of any kind. We recommend that the wording of section 246.1 should be significantly narrowed to target only the intended abuses, taking into account the various issues reviewed above and

---

[36] At the 1991 annual conference round table (question 23), the CRA was asked whether CDA can be paid out to one shareholder of a private corporation on a redemption of that shareholder's shares, or whether each shareholder of the corporation is entitled to a pro rata share of the corporation's CDA. The CRA's answer was that, so long as the anti-avoidance provisions of subsection 83(2.1) do not apply, the corporation can pay the balance of its CDA to one shareholder on a redemption of that shareholder's shares. Also, the CRA stated that CDA streaming would not, by itself, offend the provisions of the GAAR. See CRA documents nos. 2000-0026615 and 2001-0112945

specific recommendations made in the body of this part of this submission. In our view, the fact that this provision is modelled on another provision that was included in the Act many decades ago, and was generally considered to be applicable to a much narrower form of surplus stripping, is not a sufficient response to our concerns.[37]

The provision, as drafted, interferes with the operation of a number of other provisions of the Act, all of which are based on long standing fundamental principles of tax integration and symmetry. Many of these have been noted in the everyday examples above. They include, for example, the dividend refund mechanism on the payment or deemed payment of a taxable dividend, the ability to designate a taxable dividend as an eligible dividend, the distribution of life insurance proceeds to shareholders on a tax-free basis, subsection 40(3) which provides for a capital gain when there is a return of PUC in excess of ACB, safe income determination time and the other principles codified in subsection 55(2), as well as the winding-up rules in subsections 84(2) and 88(2). Section 246.1 should be amended to respect and preserve the fundamental tax principles established in these and other relevant provisions.

In addition, the re-drafting of the provision should more clearly accommodate *bona fide* commercial transactions and steps required to be completed in a conventional series of transactions to deal with the commercial reality of a particular transaction and to comply with various other provisions of the Act.[38]

Apart from questions of interpretation and uncertainty, we have concerns with the consequences of the application of the rule. An example is noted above in the context of shareholders that are trusts. We also noted above that the rule deems a taxable dividend to be received by the individual, but not to be paid by the corporation. Accordingly, any tax accounts in the corporation, such as GRIP and RDTOH, could not be used in respect of the deemed dividend. Further analysis is required to ensure that the consequences of the application of the rule are appropriate in the circumstances. At a minimum we believe that this objective would be assisted in part through the adoption of a symmetrical rule, treating a dividend as both received and paid.

We appreciate that this recommendation involves a substantial redrafting of the proposed rule. However, we do not believe that this conflicts in any way with the policy objective of

---

[37] The former provision had also been criticized because of its ambiguity, and was repealed in part for this reason.
[38] For example, the provisions should not apply in respect of the distribution of capital gain proceeds in connection with an arm's length sale of property – including related persons transacting under commercial terms. Often the pre-closing transactions related to a sale of a business to an arm's length purchaser may include the realization of a gain in a non-arm's length disposition of property, for example, when the vendor wants to ensure that the gain is included in the safe income for the series and must be realized prior to a safe income determination time event (e.g., a purchaser increasing their direct interest in the acquisition company that will acquire the business could be a safe income determination time event). If the gain is not included in safe income, it will be subject to additional tax when it is distributed to corporate shareholders as part of the series. Due to the effective elimination of the Part IV tax exception in subsection 55(2), the need for safe income to be able to make intercorporate dividend distributions is important. Under these circumstances the distribution of the CDA related to that gain to individuals should not be recharacterized under section 246.1.

preventing surplus stripping. Indeed, our comments above do not challenge the appropriateness of the stated policy objective; rather, they are focused primarily on the lack of an intelligible articulation of the scope of that objective in the text of the provision and the clear potential for serious adverse effects in a broad range of transactions that have no intersection with surplus stripping.

Finally, while we welcome guidance in the Explanatory Notes to help with the application of the provision in practice, we do not believe this alone is sufficient. The text of the provision, itself, needs to more clearly enunciate the mischief at which it is specifically aimed and the specific consequences that flow therefrom (and, hopefully it goes without saying, the consequences of the application of the rule must be reasonable in relation to this mischief and double taxation must be avoided). As noted above, for most of its life, subsection 247(1) was structured in a way that, while problematic for other reasons, allowed greater non-statutory guidance as to its application than does the proposed section 246.1. Simply put, we are concerned that here, perhaps to a greater extent than in any other recent legislative proposals, "guidance" may in fact be extra-statutory rule making, not based on the language of the section. We believe a core principle that ought to be respected in enacting statutory provisions is that their intended effect and scope should be understandable without resort to extra-statutory evidence.

4. Need for grandfathering / transitional relief

In the preceding sections of our submission we have highlighted a number of concerns regarding the likely adverse implications of the proposed changes to section 84.1 as they would apply to transfers of private corporation shares between individual family members and related parties, and for Estates and their beneficiaries in a post-mortem context, and the significant uncertainties regarding the intended application of the proposed new section 246.1.

In addition to these concerns related to the application of these measures, the fact that they are proposed to apply effective immediately upon the announcement date of July 18, 2017 causes a number of additional concerns regarding the lack of transitional relief or grandfathering. As noted previously, we believe that the measures represent significant changes to previous tax policy, and the manner in which the changes are proposed to be imposed will effectively result in their application to many transactions undertaken previously by taxpayers in full compliance with accepted rules and practices, and with legitimate expectations as to the consequences of such transactions, with no opportunity to take corrective action. We believe this would be fundamentally unfair to taxpayers and inconsistent with historical practice in our tax system when significant changes in tax policy are introduced. **Accordingly, we recommend that a number of transitional measures be provided, regardless of whether the effective date of any changes is delayed (as we recommend) or left as July 18, 2017. In that regard, in the following paragraphs, references to "July 18, 2017" would be modified to the later effective date, if the coming into force provisions of the proposed rules are delayed.**

a) *No application of proposed changes to section 84.1 in respect of capital gains realized on a "previous disposition" prior to July 18, 2017*

Although the proposed amendments to section 84.1 would be made applicable only for dispositions of a share by an individual to another non-arm's length corporation that occur on or after July 18, 2017, the revised calculations of the modified ACB determined under subparagraph 84.1(2)(a.1)(ii) would take into account any capital gain realized on a previous disposition of the share (or share for which the share was substituted) by a non-arm's length person after 1984. As a result, taxpayers in similar economic circumstances today may be faced with significantly different tax results depending on whether or not a share on which a gain was realized as long as 32 years ago was subsequently transferred to another corporation prior to July 18, 2017.

A shareholder who previously acquired a share at fair market value from a non-arm's length person with the reasonable expectation, based on the clear rules under section 84.1 at the time, that he or she would have been able to subsequently transfer that share to another corporation for boot or shares without being subject to deemed dividend treatment or PUC reduction may well have delayed making such a transfer for any number of reasons. (Ironically, this will most often be the case in situations involving "genuine business transfers" where surplus stripping was not even a consideration, as there may not have been a pressing need or desire to immediately access or withdraw funds from the corporation.) The acquiring person may not have even been aware of whether the selling individual was realizing a capital gain, let alone what the amount of the gain was.[39]

The retrospective application of the "previous dispositions" for which gains would be relevant could particularly impact taxpayers who had deemed dispositions in a prior year, including individuals who immigrated to or emigrated from Canada, or who died, while holding shares, or personal trusts that held (or still hold) shares to which the "21-year anniversary" rules applied. Especially where such events occurred in the recent past, in many cases the individuals, estates or trusts, as the case may be, might not have taken steps to deal with the increased ACB in the shares resulting from the deemed disposition.

The impact on an Estate could be severe. Consider an individual who died in early July of 2016 and realized a capital gain on the deemed disposition of shares. Based on the nature of the corporation and the particular shares previously held by the deceased, a plan may have been developed that relied on the "pipeline strategy" described earlier (and which was consistent with similar plans that have been given positive rulings by the CRA). For various administrative, legal or non-tax business reasons, it is not uncommon for the implementation of such post-mortem planning to require more than one year. Accordingly, where the transfer of shares by the Estate to a new corporation had not occurred by July 18, 2017, the Estate would no longer

---

[39] As noted earlier regarding potential administrative difficulties with the proposals, the shareholder today may have no information regarding the amount of previous gains, which may have occurred many years ago, and have no ability to determine the necessary information.

be able to implement the plan (possibly after already spending significant time and expense arranging to do so) and yet would also be unable to implement a revised double-tax avoidance plan relying on subsection 164(6) because the one taxation year time limit under that provision would have expired. Trustees of Estates for individuals who died less than a year ago and that had similarly planned to undertake a pipeline strategy that had not been completed by July 18, 2017 have been placed in an equally unfair position of having to decide whether to undertake subsection 164(6) planning as an alternative (and with very little time to consider the implications) to avoid potential future double tax, but at a higher tax cost than had originally been expected, or wait for the end of the consultation period to see whether changes to the proposals might be made which would make a revised plan unnecessary (and with the prospect of an "incorrect" choice leading to potential litigation from beneficiaries).

Accordingly, we recommend that the proposed changes to section 84.1 not apply in respect of capital gains realized on a "previous disposition" prior to July 18, 2017. Simply put, any ACB related to acceptable transactions under law before the announcement date should be grandfathered. Similar coming-into-force language was applicable to the GAAR.

b) Proposed section 246.1 should not apply in respect of a series of transactions that began prior to July 18, 2017

As noted in our concerns outlined above regarding proposed section 246.1, given the potentially extremely broad interpretation of when a particular transaction will be considered to form a part of a "series of transactions", we are concerned that many "distributions" made on or after July 18, 2017 could be said to form part of a series of transactions that began prior to the announcement of this proposed measure and were totally in compliance with the laws in force when the series began.

For example, a capital gain may have been realized previously (in some cases, many years previously) on which corporate tax was paid, but a portion of the resulting capital dividend account is only paid out subsequent to July 18th. It is possible that any capital dividend paid will be considered to be part of a series of transactions that includes an earlier transaction in which a capital gain was realized that affects the current capital dividend account balance. Although it is unclear whether one of the purposes of a series of transactions is "tax avoidance" could be determined based on the purpose of only one of the transactions forming part of that series (the payment of the capital dividend, for example), where another transaction by itself (the original transaction in which the capital gain was realized) did not have the requisite purpose, it appears possible that at least in certain cases the payment of a current capital dividend in those circumstances could be subject to the proposed rule, and therefore be treated as a taxable dividend to the shareholder, resulting in double tax.

As another example, depending on how the section is interpreted (and how, in practice, the CRA administers the rule), it is possible that current returns of capital or debt principal payments on shares or promissory notes that were received many years ago in transactions that, if undertaken today, might be subject to the rule, could be considered "amounts received" after July 18, 2017, such that transactions and what we would normally think of as "distributions" completed prior to that date nevertheless become subject to the rule. For example, an Estate that completed a "pipeline" transaction many years ago in compliance with the existing rules in section 84.1, or a beneficiary of the Estate, that continues to hold high-PUC shares or debt of a corporation resulting from those transactions could potentially become subject to the rule when shares are redeemed or payments on the reduction of stated capital are received, or when the debt is repaid, subsequent to July 18, 2017.

Many other variations are possible in which taxable transactions undertaken previously in compliance with the rules at that time could form part of a series that includes a distribution received by an individual shareholder subsequent to July 18, 2017 and which series (whether viewed as a whole or otherwise) could be considered, based on the proposed changes to section 84.1 and new section 246.1, to have the required tax avoidance purpose. We believe that it would be unfair and inappropriate to subject taxpayers in these circumstances to what amounts to retrospective double taxation.

Accordingly, we recommend that proposed section 246.1 not apply in respect of amounts received in respect of a transaction or event, or a series of transactions or events, that began prior to July 18, 2017.

c) Proposed section 246.1 should not apply in respect of capital dividends paid at any time out of the balance in a corporation's capital dividend account immediately prior to July 18, 2017

As noted above, there is significant uncertainty in particular regarding whether the payment of a capital dividend must, in effect, always form part of a series of transactions that includes a previously realized capital gain, the non-taxable portion of which forms part of the capital dividend account balance. In addition, there is uncertainty as to whether the payment of a capital dividend could by itself potentially be considered to be subject to the rule in proposed section 246.1 (for example, because it involves the disposition of property – the cash paid to the shareholder is property disposed of by the corporation – and the tax payable by the shareholder in respect of the amount is less than the amount that would have been payable on a taxable dividend).

Accordingly, to avoid creating inappropriate uncertainty regarding every capital dividend payment, **we recommend that proposed section 246.1 specifically not apply in respect of capital dividends paid at any time by a particular corporation to an individual shareholder to the extent of the balance in the capital dividend account of that corporation immediately before July 18, 2017 (and that this exclusion also apply in respect of amounts added to the particular corporation's capital dividend account balance at any time in respect of capital dividends received from another corporation that was connected with the particular corporation immediately before July 18, 2017 and that would have been excluded from the application of proposed section 246.1 under this exclusion if it were paid to an individual shareholder).**

Concluding comments on grandfathering / transitional relief

Our recommendations regarding transitional rules are based on our view that the proposed amendments to section 84.1 and introduction of section 246.1 are clearly changes in tax policy. Many of the steps taken by taxpayers in the past were verified by either the courts or the CRA (or both). To implement these changes in the same manner as closing a tax loophole (i.e. without appropriate grandfathering and transitional rules) is unfair and contrary to the basic tenets of a sound tax system.[40]

[40] See the submission made by CPA Canada, which discusses the "Principles of a Sound Tax System".