

# New Section 84.1 Overview

*September 14, 2021*

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## New Section 84.1

### Overview

Section 84.1 stops use of capital gains exemption to strip corporate funds.

Capital gain is recharacterized as a dividend to extent cash or note is taken back

Applies in non-arm's length situations

Sale to arm's length person gives better result than sale to family members (e.g. children)

This is unfair

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## Example

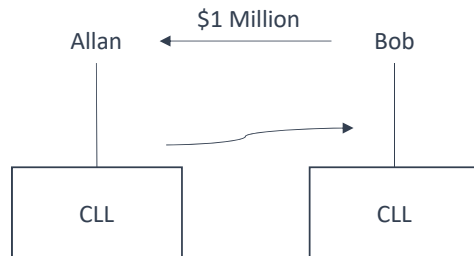
City Laundry Ltd (CLL) is owned 100% by Allan.

CLL is small business corporation

Value of shares \$1 million

Son Bob is active in the business

Allan wants to sell to Bob



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## Result for Allan

Allan claims capital gains exemption (only around \$100,000 of capital gain not exempt). Allan's tax (ignoring AMT) is about \$25,000

Good result for Allan

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## Result for Bob

Bob has ACB on CLL shares of \$1 million  
Bob cannot use ACB to take out corporate funds.  
Bob looks at two alternatives

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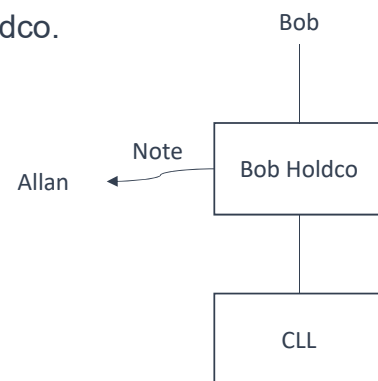
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CLL funds note with dividends over time paid to Bob Holdco.

Bob Holdco pays note to Allan

Result - Allan has ineligible dividend, no capital gain

- Allan's tax now about \$480,000
- Bad result for Allan



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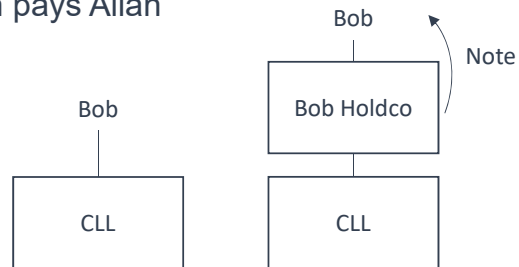
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## Old Section 84.1

Bob buys CLL shares, transfers to Bob Holdco for note.

Bob receives payments then pays Allan



Results - Allan has capital gain, can claim capital gains exemption

- Bob has ineligible dividend for amount of note. Tax to him \$480,000
- Bad result for Bob

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Both results are bad for someone.

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Allan has offer from Megalaundry Inc. (MI) unrelated

Alan can sell to MI, claim capital gains exemption

MI pays Allan over time from its after-tax earnings

Good result for everyone

MI will pay more because of better tax result

Unfair for family business succession.

But how to fix the problem?

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### History

Section 84.1 changed in 1985 when capital gains exemption began.

Issue for 36 years! Cannot strip capital gains exemption ACB if related.

In 2020 private member bill to change this (recycled from previous attempts).

No amendments to bill as it went through legislative process.

Passed into law June 29, 2021

Department of Finance did not support (too many loopholes) but acted late, objections recognized but denied.

Main problem is lack of requirement for legitimate succession

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## History cont'd

Government announced it would repeal retroactively. Big fuss ensued. Said then it would amend to correct errors but effective no earlier than November 1, 2021.

May be limited time window

People pointed out loopholes in new rule. Opportunities to strip earnings using capital gains exemption even when true succession not carried out.

Many firms promoting plans to exploit short window of opportunity

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## History cont'd

Arguable that legislation doesn't reflect the intent of parliament

Plans may have some risk

Challenge under GAAR, especially based on recent GAAR cases?

Retroactive change possible? Probably off the table given the November 1 date

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## What New Rule Says

Purchaser corporation (Holdco) controlled (does not require “real” ownership or value) by one or more children or grandchildren age 18 or older.

No sale of subject shares (Opco shares) within 60 months

Must be qualified small business corporation shares or shares of family farm or fishing corporation

Special rules apply if Opco shares sold within 60 months

Allows planning, possibly unintended – sell to Newco controlled by children and take back a note and common shares

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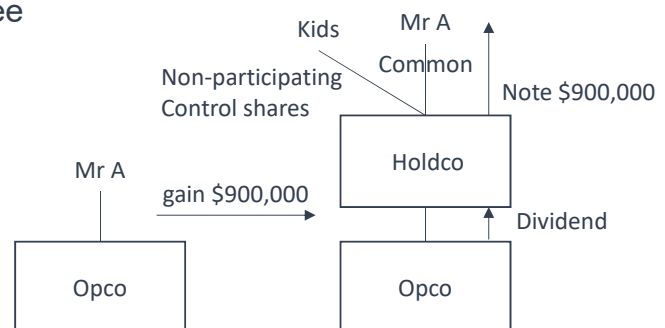
## Cake and Eat it Too

Realize \$900,000 capital gain. Exempt under capital gain exemption. Fund with corporate money, take out via note tax-free

Tax savings vs dividend

$$\$900,000 \times 39.34\% = \$300,600$$

$$\$900,000 \times 47.74\% = \$429,600$$



This is what old section 84.1 was intended to stop!

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## Example

Opco owned 100% by Chris (father).

Son Donald is age 18 (does not need to be active in Opco).

Opco shares are QSBC shares.

Chris and Donald set up Holdco (purchaser)

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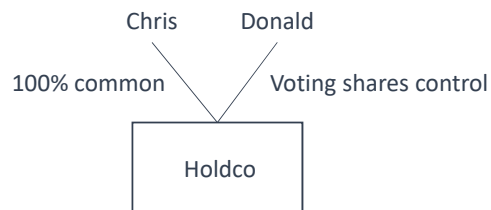
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## Example Continued

Chris (father) owns 100% of common shares. Donald has voting shares, nominal value but controls.



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## Example continued

Chris sells 100% of Opco to Holdco for common shares and note of \$900,000

Opco over time pays dividend to Holdco, pays off note to Chris.

55(2) does not apply to intercorporate dividend because “related”

Chris strips out \$900,000 tax free from Opco using capital gains exemption with no succession of business

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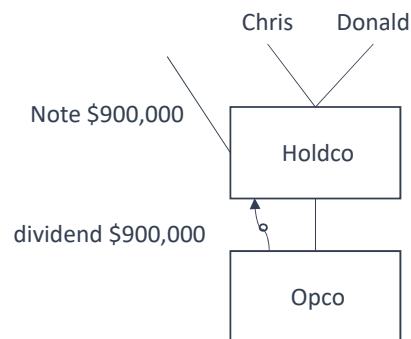


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## Structure



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## Other Conditions

Hard to interpret what they mean

If Opco shares sold within 60 months (other than by reason of death), rule excluding application of section 84.1 does not apply.

Capital gains exemption might be reduced if taxable capital over \$10 million, eliminated at \$15 million. Very unclear how this works.

Must provide CRA with independent assessment of FMV and affidavit signed by taxpayer and 3<sup>rd</sup> party attesting to disposal. No time limit provided for doing this.

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## Do you promote this plan?

Time limited opportunity before legislative correction. Per government, not before November 1 (but who knows).

Could GAAR be applied?

Blatant strip plans versus bona fide succession plans?

Note could be recharacterized as dividend subsection 84(2) under MacDonald case principles (maybe)

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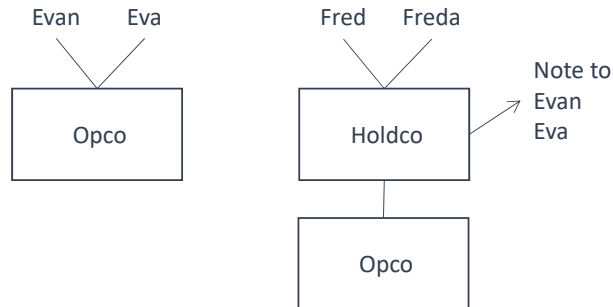
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## Bona Fide Plan

Evan and Eva own Opco

They want to pass on Opco to adult children Fred and Freda who are active in Opco



Opco retained long term

Seems well within written intent

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## What to Do?

Seems clear bona fide plans can go forward (at least if done by November 1, 2021).

If done primarily for family business succession, good defence against GAAR.

Pay off Holdco note gradually over time (not a blatant strip).

Big advantage for children to buy the company with funds generated over time in the future.

The change we have been advocating for years

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## More Aggressive Approaches

Note that cash not used in business must be under 10% of FMV. Opco must be SBC.

So ability to do quick strip could be limited.

But might be able to borrow to fund dividends, pay off note. Interest should be deductible if loan not more than retained earnings.

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## Action

Review client base for possible interest.

Determine risk profile and advise client of risk

Determine reputational risk to your practice

- Children active
- Bona fide transition
- Estate planning reasons

Low Risk

- Children not active
- Used only to make plan work
- Quick strip

Higher Risk

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## Action - continued

Need to know FMV

Need to check all aspect of capital gains exemption availability

May be restrictions on use of trust

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