Avoiding Dividend Treatment

October 30 & 31, 2018

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Avoiding Dividend Treatment

Confusing World

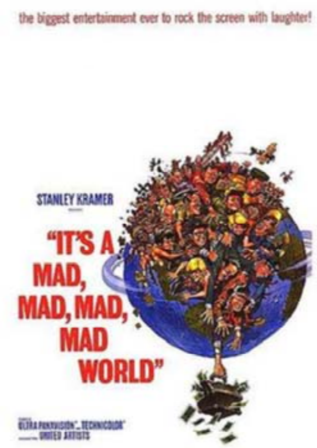
Section 84.1 – Capital gain or use of ACB deemed a dividend

Subsection 84(2) – Use of ACB deemed a dividend

Subsection 120.4(4) – NAL capital gain under age 18 deemed a dividend

But

Section 55 – Intercorporate dividend deemed a capital gain if in excess of safe income



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There are several sections which can transform a capital gain into a dividend. The most common piece is section 84.1. The main way in which section 84.1 applies is with the claiming of capital gains exemption and extraction of funds from a corporation by either the person who claimed the exemption or a related person. However, section 84.1 has some hidden traps which apply and result in dividend treatment which is unexpected.

The second provision is subsection 84(2). This derives from a broad interpretation of the provision which is based on the decision of the Federal Court of Appeal.

The third provision is subsection 120.4(4) This is part of the TOSI rules, but in addition to applying tax at the top tax rate, the capital gain is re-characterized to a dividend. Unfortunately, the entire capital gain and not 50% of the capital gain is deemed to be an ineligible dividend. This results in a massive tax increase and compared to a capital gain which would be claimed under the capital gain exemption. However, it applies whether the capital gains exemption is claimed or not.

To show how confusing and chaotic the provisions are, there is another provision which re-characterizes a dividend to be a capital gain. This is for inter-corporate dividends in certain circumstances for the amount of the dividends that exceeds safe income. This provision is section 55. It is not discussed in these notes because it is a separate and very complex subject. In this circumstance we are dealing with the situation of individuals.

Avoiding Dividend Treatment

Advantages of Capital Gains

- Tax rate 26.7% versus 39% or 47%
- Payout of CDA tax free (if gain in corporation)
- Take out ACB from corporate group tax free
- Capital gains exemption
- Capital gains reserve
- Spousal rollover
- Use of capital losses to offset
- Claim ABIL if SBC
- Broader exemption from TOSI (QSBC shares)

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There are many advantages to having a capital gain and avoiding deemed dividend treatment. These include the following:

i. The tax rate on a capital gain is far less than the tax rate on a dividend at higher tax brackets. At the top tax bracket the comparison is 26.7% for a capital gain versus 39% (eligible dividend) or 47% (ineligible dividend). Thus an ineligible dividend is taxed at around 20% higher than the tax rate on a capital gain at the top tax bracket.

ii. If a capital gain is received in a corporation, then 50% of the capital gain can be paid out as a capital dividend.

iii. Having adjusted cost base on shares, created through a capital gain or through the purchase of the shares in some way can allow corporate funds to be extracted on a tax free basis. This is referred to as a pipeline type transaction and examples are shown later.

iv. The capital gain may be eligible for the capital gains exemption, in which case no tax may be paid on the capital gain.

v. Where a capital property is sold and not all of the proceeds are received, a capital gains reserve can be claimed. The maximum capital gain reserve in the first year is 80% of the sale price, declining at the rate of 20% per year. Thus the capital gain is repaid in full over 5 years. Where shares of the small business corporation are sold to a child or grandchild, the reserve that can be claimed for unpaid proceeds allows the gain to be spread out over 10 years instead of 5 years.

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vi. A capital gain can be eligible for a spousal rollover on a transfer to a spouse or a spousal trust. Also the capital gain can be deferred to an alter ego or joint partner trust. There is no such deferral applicable to a dividend.

vii. An individual may have capital losses in the year or capital losses from previous or subsequent years which can apply to offset the capital gain.

viii. A capital loss from the disposal of shares of debt of a small business corporation can be claimed as an allowable business loss in certain circumstances. This allows 50% of the capital loss to be deducted against other income.

ix. Lastly, the exemptions from the TOSI rules are broader for capital gains than for dividends. The capital gain realized on death is not subject to TOSI. Also, a capital gain from the disposition of shares of a qualified small business corporation is not subject to TOSI, whether or not the capital gains exemption is claimed or even available.

These factors make capital gains far more attractive than deemed dividends.

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Share Redemption

Canadian private corporation

Redemption proceeds less PUC = deemed dividend

PUC = proceeds of sale

Capital gain = proceeds - ACB

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Where shares of a Canadian private corporation are redeemed, the redemption proceeds less the paid up capital results in a deemed dividend. Paid up capital is the legal stated capital of the shares of the class, as modified by certain provisions in the Income Tax Act if applicable. The paid up capital or PUC used in the calculation is the amount by which the PUC of the share class is reduced as a result of the redemption.

The PUC is re-characterized from being a deemed dividend to being proceeds of sale used in the capital gains or loss calculation. The capital gain is the difference between the proceeds (the paid up capital on a share redemption) less the adjusted cost base.

Avoiding Dividend Treatment

Example

Mitchell owns 100 shares in MCo
PUC of share class $10,000, 200 shares issued.
Redemption of 50 shares.

Redemption proceeds $60,000
Mitchell's ACB $4,000 for 100 shares

Redemption Proceeds $60,000
Deemed Dividend : $60,000 - $2,500 = $57,500

Proceeds for capital gain : $2,500
Capital Gain: $2,500 - $2,000 = $500

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In this example Mitchell owns 100 shares of a Canadian private company MCo. The paid up capital of the class of shares is $10,000 and there are 200 shares issued. Assume for simplicity that there are only common shares issued.

Mitchell will redeem 50 shares of the corporation and will receive redemption proceeds of $60,000. Assume that Mitchell's ACB for his 100 shares is $4,000.

The redemption proceeds from the dividend is $60,000. The amount of the deemed dividend is the redemption proceeds less the paid up capital of the shares redeemed. The paid up capital of the shares redeemed is based on the paid up capital of the class being $10,000, and his redeeming 50 shares out of 200 shares. Thus the paid up capital of the shares redeemed is $2,500. So the deemed dividend is $57,500.

The paid up capital of the shares redeemed becomes proceeds for purposes of the capital gain calculation. Thus the proceeds will be $2,500.

The ACB of Mitchell's shares which are redeemed is $2,000 (his ACB for 100 shares is $4,000 and he is redeeming 50 shares). Thus the capital gain is $500.

Avoiding Dividend Treatment

Impact of Share Redemption

Deemed dividend (higher tax than capital gain)

No capital gains reserve

No capital gains exemption

Less broad TOSI exemption

But distribution of corporate funds

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As noted earlier, a deemed dividend results generally in much higher tax than a capital gain. There is no ability to claim a capital gains reserve for un-remitted proceeds of sale (in this context: distribution). Also, there is no ability to claim the capital gain exemption. Lastly, the exemption in the TOSI rules is less broad for dividends than for capital gains.

However, a share redemption results in a distribution of corporate funds where a sale of shares does not. It is necessary to carry out further steps in order to extract corporate funds.

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<u>Pipeline Transaction</u>

Uses ACB to extract corporate funds

Beware of rules that deem a dividend to arise

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A pipeline transaction is a transaction where the adjusted cost base of shares is extracted from a corporate group, usually through creation of a holding company, a note, a dividend payment and a payment of the note. There are many examples of pipeline type transactions in the slides which follow.

It is mainly towards this type of transaction that the deemed dividend rules in section 84.1 apply. Thus if this type of transaction is going to be carried out, it is necessary to avoid the deemed dividend treatment of section 84.1.

Avoiding Dividend Treatment

Section 84.1

Common issue and hidden traps

Deems dividend to arise (ineligible)

Common example – extract ACB from NAL use of capital gains exemption

But applies also in other circumstances

Some are surprising

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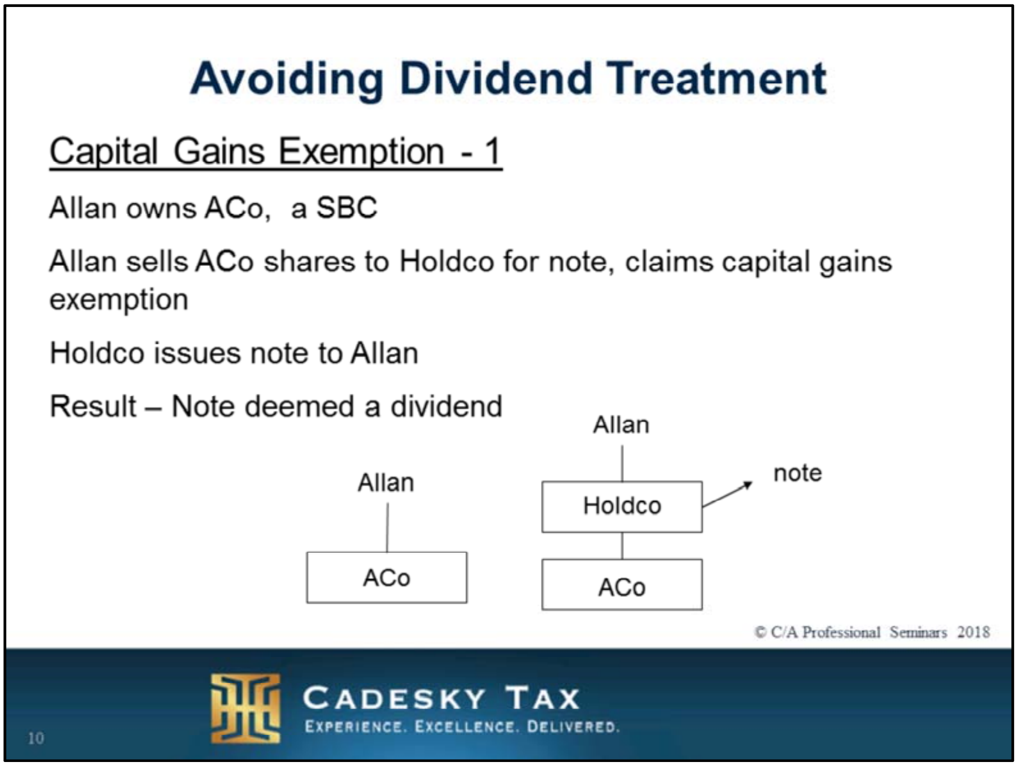
Section 84.1 has some common issues especially with respect to the capital gain exemption, but also a number of hidden traps. If it applies. It results in the capital gain being re-characterized to an ineligible dividend.

A common example is extracting the adjusted cost base of shares where the adjusted cost base is risen from the non-arm's length use of the capital gain exemption.

However, section 84.1 can apply in other circumstances and some of the situations are surprising and unexpected. The following slides show common examples of which section 84.1 can apply.



The first example shows how section 84.1 can apply in a situation where a shareholder, Allan, directly transfers shares to a holding company and claims a capital gains exemption. Assume that Allan owns shares of ACo, which is a small business corporation. Allan sells the shares of ACo to Holdco in exchange for a note and claims the capital gains exemption. Holdco then receives a dividend from ACo, and pays off the note to Allan.

The result is that the note when issued is deemed to be a dividend. This is a direct application of section 84.1.

As will be shown on a later slide, even if Allan does not claim the capital gains exemption, the note can still be a deemed dividend in this case. However, if Allan has adjusted cost base in his shares of ACo which came from arms length sources (i.e. all the contribution with his own capital on the issuance of the shares), this can be extracted via the note.

Despite the fact that section 84.1 in its current form has been in place since 1985 when the capital gains exemption was introduced, people still attempt this type of transaction which falls squarely within section 84.1.

For Allan, his attempt to use the capital gains exemption in this way results in dividend treatment.

CPAs are expected to know the consequences of engaging in sale transactions such as this and the others which follow, and recommending such a transaction, while failing to identify correctly the consequences, will often result in a lawsuit.

Also, if the transaction is changed so that Allan receives high paid up capital shares of Holdco instead of a note, section 84.1 will apply to the extent of the increase in the paid up capital from the paid up capital of the shares of ACo.

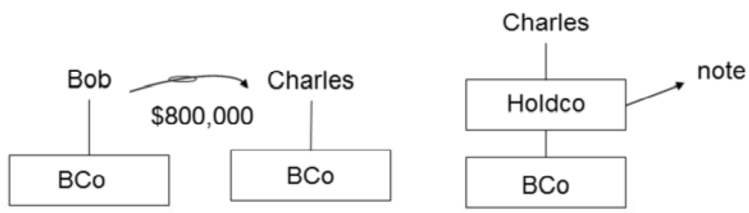
Avoiding Dividend Treatment

Capital Gains Exemption - 2

Bob sells BCo, a SBC, to son Charles for cash of $800,000 (assumed FMV). Bob claims capital gains exemption

Charles transfers BCo to Holdco for note of $800,000

Result – Note is deemed a dividend to Charles



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In this example Bob sells shares of BCo, a small business corporation to his son Charles in exchange for cash of $800,000 which is assumed to be the fair market value. Charles, having paid $800,000 for the shares of BCo transfers the shares to Holdco in exchange for a note.

The result is that the $800,000 note is deemed to be a dividend to Charles. This is because Bob, a related person, has claimed the capital gains exemption. In this example if Bob did not claim the capital gains exemption, Charles would be able to carry out the transaction with the promissory note and extract funds from BCo through a dividend to Holdco and repayment of the note. However, this is subject to the further comments on subsection 84(2) which follow which could potentially still result in dividend treatment.

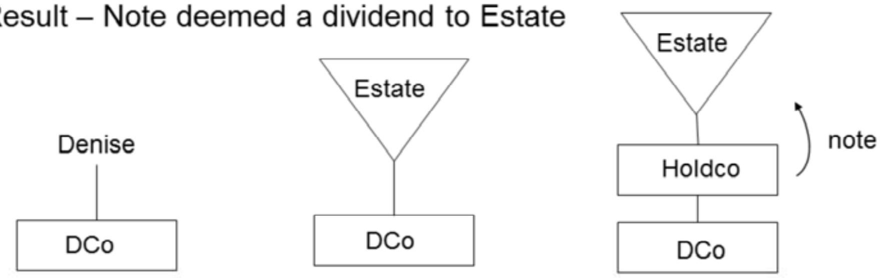
Avoiding Dividend Treatment

Capital Gains Exemption - 3

Denise dies, owned shares of DCo, a SBC, FMV $600,000. Denise claims capital gains exemption

Estate transfers DCo to Holdco for note of $600,000

Result – Note deemed a dividend to Estate



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In this example Denise, dies owning shares of DCo which is a small business corporation. Assume the shares have a fair market value of $600,000. Denise claims the capital gains exemption on her tax return for the year of death.

The estate obtains the shares of DCo at an adjusted cost base of $600,000. The estate then transfers the shares of DCo to Holdco in exchange for a note. A dividend is paid from DCo to Holdco and the note is repaid to the Estate.

In this example, the note is deemed to be a dividend for the same reasons as in the two examples above.

Interestingly, if the capital gains exemption was not claimed, then the transaction could proceed as planned. Given that the tax rate on a dividend is substantially higher than the rate on a capital gain, it might be beneficial for Denise not to claim capital gains exemption in this example.

Avoiding Dividend Treatment

No Capital Gains Exemption – 1

Evan wants capital gain instead of dividend from ECo.

Either ECo is SBC and no exemption claimed, or ECo not SBC

Evan sells ECo to Holdco at FMV for note

ECo pays dividend to Holdco, Holdco pays off note

Evan extracts cash at note of capital gain.

Result - Note deemed a dividend

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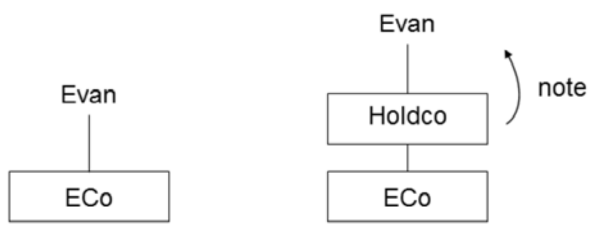
Evan owns shares of ECo. He wants to obtain capital gains treatment instead of dividend treatment on a distribution of funds from ECo. In this example one can either assume that ECo is a small business corporation but no amount of the capital gains exemption will be claimed by Evan, or, in the alternative, ECo is not a small business corporation.

Evan carries out a pipeline type transaction selling the shares of ECo to Holdco at fair market value in exchange for a promissory note. ECo pays a dividend to Holdco and Holdco pays off the note as a result, Evan <u>assumes</u> that he has succeeded in removing funds from ECo at a capital gains rate.

Avoiding Dividend Treatment



Avoid this result by creating capital gain in share reorganization <u>before</u> transfer to Holdco (not on sale to Holdco)

But subsection 84(2) could apply (see slides later)

The result is that the note is deemed to be a dividend.

This is a curious result because the capital gains exemption is not claimed. However, section 84.1 still applies. The reason is that in this transaction the gain is realized on the sale to Holdco. Because of the way that section 84.1 is constructed, deemed dividend treatment results instead of a capital gain because the capital gain is realized on the sale to Holdco.

This transaction could be changed so that Evan realizes the capital gain in another way before the transfer to Holdco. Thus when the shares of ECo are transferred to Holdco they already have a high adjusted cost base. This could be done through a reorganization through the shares of ECo, converting the shares from one class to another, and having a capital gain result. Then subject to the possible application of subsection 84(2), the transaction should succeed and produce the desired result.

Avoiding Dividend Treatment

No Capital Gains Exemption – 2

Francis sells FCo to his brother Gary for $1 million.

FCo is a SBC

Francis has $500,000 of capital gains exemption available

Francis takes note from Gary and claims capital gains reserve of $800,000 in year of sale.

Francis and Gary agree Francis will not claim capital gains exemption so Gary can extract $1 million over time from FCo tax free.

Gary puts shares into Holdco for $1 million note.

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In this example Francis owns shares of FCo and sells them to his brother Gary for $1 million. FCo is a small business corporation and the share would qualify for the capital gains exemption at the time of sale. Francis has $500,000 of capital gains exemption available. Francis takes back a note from Gary and claims a capital gains reserve of $800,000 in respect of the $1 million sale price (because $800,000 or more of the sale proceeds is unpaid).

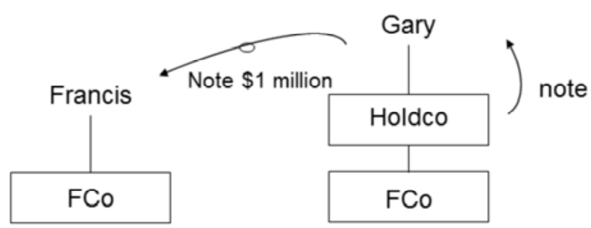
Francis and Gary both agree that Francis will not claim the capital gains exemption so that Gary can extract $1 million of funds from FCo tax free. That has been worked into the sale price and the mechanics of the overall transaction.

Confident in this approach and with an adjusted cost base of $1 million on the shares of FCo, Gary puts the shares of FCo into Holdco for a $1 million note.

Avoiding Dividend Treatment

Result – Gary has $500,000 dividend

Why – When Francis claims capital gains reserve of $800,000 he is deemed for section 84.1 to claim all available capital gains exemption



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The result is that Gary has a deemed dividend of $500,000.

The reason for this is a special rule is section 84.1 which states that where a capital gains reserve is claimed, the seller is deemed to have claimed the capital gains exemption in an amount equal to the lesser of the amount of the reserve ($800,000 in this case) or the amount of the capital gains exemption which could be claimed ($500,000). Under this rule, the capital gains exemption is deemed to be claimed for purposes of section 84.1 whether or not it is in fact claimed. Thus the plan is unsuccessful, because Francis claims a capital gains reserve. However, Gary is the one who suffers the adverse result in this circumstance.

This is a harsh result and one of the traps in section 84.1.

Avoiding Dividend Treatment

<u>No Capital Gains Exemption – 3</u>

Non-arm's length for section 84.1 has extended meaning

Subject Corporation – corporation whose shares are sold

Purchaser Corporation – corporation that buys the shares

Taxpayer deemed non-arm's length if:

- Before sale, one of group of 5 or less that controlled Subject Corporation
- After sale, one of group of 5 or less that controlled Purchaser corporation

Any group can control corporation for section 84.1

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The next example of the application of section 84.1 is more subtle than most of the previous examples. Normally section 84.1 only applies where the seller deals non-arm's length with the purchaser. However, for purposes of section 84.1 there is an extended meaning of non-arm's length.

In order to understand this, there are two terms which are used in section 84.1, Subject Corporation and Purchaser Corporation. The Subject Corporation is the corporation whose shares are being sold. The Purchaser Corporation is the corporation that purchases the shares.

An individual is deemed to deal at non-arm's length if the individual before the sale is one of a group of five or less persons that control the Subject Corporation (the corporation being sold) and after the sale is one of a group of five or less persons that control the Purchaser Corporation.

For purposes of section 84.1, any combination of shareholders that have a majority of the voting rights of a corporation can be said to control the corporation. So for example if the Purchaser Corporation is in fact controlled by one person, but there is a larger group of ownership, that larger group of owners can be viewed as a group that controls the corporation. This is best illustrated by an example.

Avoiding Dividend Treatment

<u>Example</u>

Subject Corporation	– Howard	20%
	– Isaac	20%
	– John	40%
	– Kathy	20%
Purchaser Corporation	– Howard	60%
	– John	35%
	– Kathy	5%

Are all unrelated

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In this example, Subject Corporation (the corporation being sold) is owned by four individuals Howard 20%, Isaac 20%, John 40%, and Kathy 20%. No one individual controls the subject corporation.

After the sale, another corporation, the purchaser corporation, is owned 60% by Howard, 35% by John and 5% by Kathy.

Although the example does not explain how this ownership arises, it should be noted that the Purchaser Corporation may have other assets, and a different ownership to the Subject Corporation before the transaction. Also, in this example Isaac receives cash and Kathy might receive some amount of cash on the sale, and therefore the ownership in Purchaser Corporation is not proportionate to that of Subject Corporation. This is simply to show various variations in how the rule applies.

We assume that all of these individuals are unrelated.

Avoiding Dividend Treatment

Howard is aware of section 84.1 issue. He rolls over his shares and no capital gains exemption are claimed

Isaac not a shareholder of Purchaser Corporation, he is fine.

John and Kathy claim capital gains exemption $600,000 and $300,000.

John and Kathy deal at arm's length with Purchaser Corporation since Howard controls it

But for section 84.1 Subject Corporation and Purchaser Corporation are deemed non-arm's length

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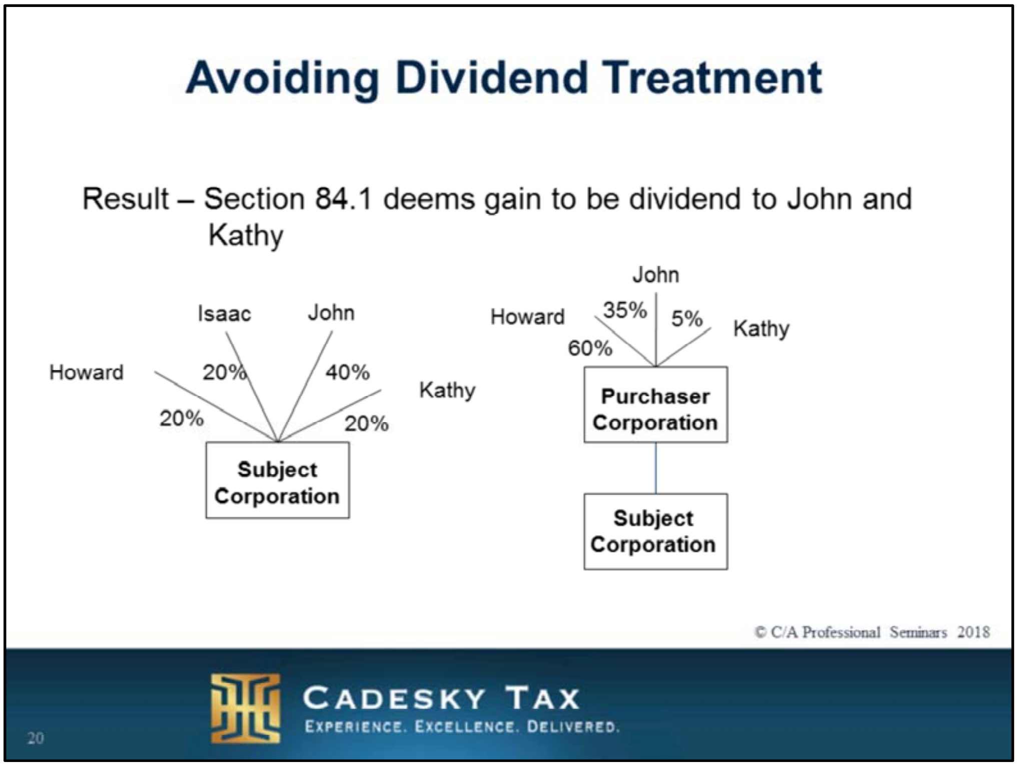
Howard received specialized tax advice and was informed of the issue concerning section 84.1. As a result, on his sale of Subject Corporation shares to Purchaser Corporation he did not claim the capital gains exemption, and he transferred his shares on a rollover basis.

Isaac is not a shareholder in Purchaser Corporation nor is he related to any shareholder. As a result, the rule does not apply to him and he can claim his capital gains exemption.

John and Kathy claim their capital gains exemptions of $600,000 and $300,000 respectfully. They anticipate that the sale will be tax free.

Because John and Kathy deal at arms length with the Purchaser Corporation as a question of fact and do not control the Purchaser Corporation after the transaction, they assume that they do not have any obstacles in claiming the capital gains exemption. It is clear that Howard controls the Purchaser.



However, for purposes of section 84.1, Subject Corporation and Purchaser Corporation are deemed to be non-arm's length and John and Kathy are deemed to deal non-arm's length with both Subject Corporation and Purchaser Corporation. Because section 84.1 applies to them to deny the capital gains exemption, this results in dividend treatment.

Avoiding Dividend Treatment

Selling part of the shares and staging as shareholder of Purchaser Corporation or becoming shareholder of Purchaser Corporation is problem.

Be careful. Check rules in 84.1

Trap for unwary

Most common reason CPAs sued.

See *Emory v The Queen 2010 TCC 71*

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In the event that shareholders sell part of their shares, but continue to be shareholders in the Purchaser Corporation, this is a problem for claiming the capital gains exemption. It can apply even if the ownership percentage is small, for example Kathy has only 5%.

This is a hidden trap for the unwary. It was the subject of a case *Emory versus The Queen 2010 TCC 71*, where the taxpayer unsuccessfully argued that section 84.1 should not apply in a circumstance very similar to what is described here.

Avoiding Dividend Treatment

Subsection 84.1 and GAAR

Ingenious ways found to avoid section 84.1

Technical ways, step transactions, complex sequences.

Courts have sided with CRA on GAAR attack

People have tried to find various ways around section 84.1. They have created technical arguments, complicated sequences of steps, usually hidden step transactions.

Where section 84.1 would have applied but for certain technical arguments that work around the rules, CRA has tried to apply GAAR . CRA has been successful in their approaches, and there are many court cases where taxpayers have been unsuccessful in finding ways around section 84.1.

Below is a list of the cases involving section 84.1 and GAAR and the outcome.

Descarries, 2014 TCC 75, (Tax Court of Canada), GAAR applied

Pomerleau, 2018 FCA 129, (Federal Court of Appeal), GAAR applied

Desmarais, 2006 3 C.T.C 2304 (TCC), (Tax Court of Canada), GAAR applied

1245989 Alberta Ltd. (Wild), 2018 FCA 114, (Federal Court of Appeal), GAAR did NOT apply

Avoiding Dividend Treatment

<u>Subsection 84(2) – Deemed Dividends</u>

Canada v MacDonald 2013 FCA 110

Dr. MacDonald owned a PC

PC was deregistered

Shares of PC sold to brother-in-law (JS)

JS transferred shares to Holdco (601798 NB Ltd) for note.

Dividends paid by PC to Holdco, note paid out to JS

JS paid Dr. MacDonald had capital losses to offset capital gain.

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Subsection 84(2) has been given a very broad meaning in the Federal Court of Appeal case of Canada versus *MacDonald 2013 FCA 110.*

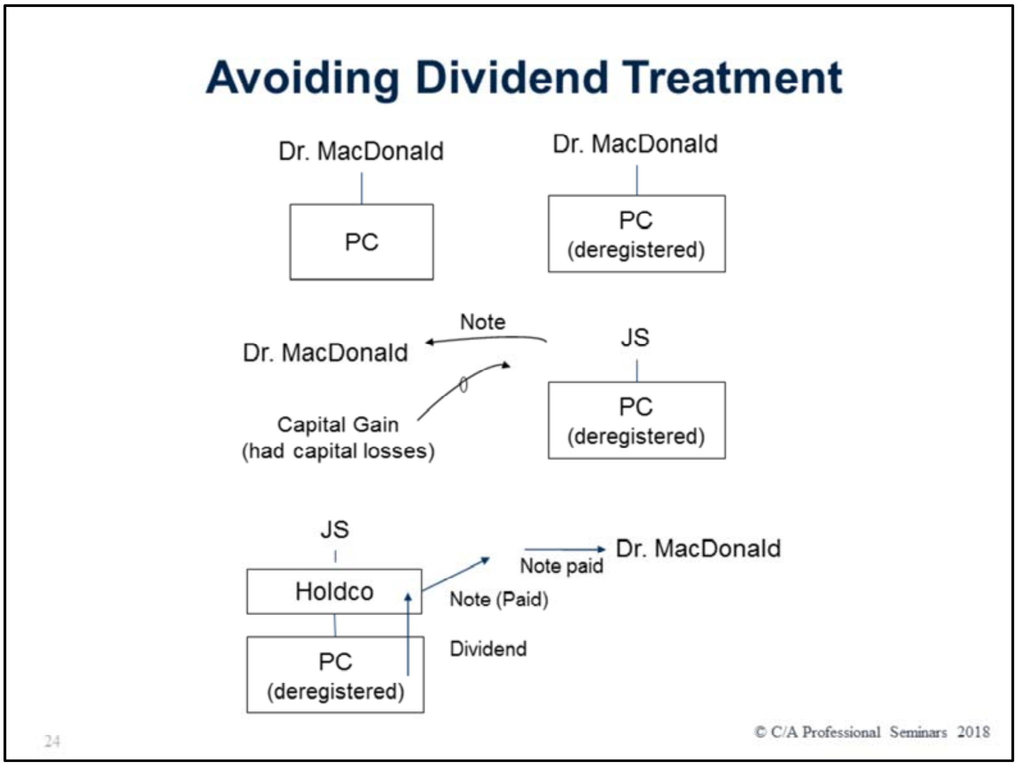
Dr. MacDonald was a doctor practicing in New Brunswick, who moved to the U.S.. As part of the move to the U.S. he carried out certain tax planning. The first step was that the professional corporation was deregistered, because he intended to transfer it to someone who was not a medical doctor.

After this, the shares of the professional corporation were sold to his brother-in-law (JS).

JS then transferred the shares to a holding company (Holdco) for a note.

Dividends were paid from the professional corporation (now deregistered) to Holdco and the note was paid out to JS. JS then paid Dr. MacDonald the amount of his note.

While not directly relevant to the issue, Dr. MacDonald had capital losses which were able to offset the capital gain that he realized on the sale of the shares to his brother-in-law.



These diagrams describe the steps carried out in simplified terms.

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Result – Sale by Dr. MacDonald deemed a dividend

Why – Subsection 84(2). Funds or property of corporation resident in Canada distributed or otherwise appropriated in any manner whatever to or for benefit of shareholder on windup, discontinuance or reorganization of its business …is dividend. Amount is FMV received less PUC reduced on shares.

Here PC wound up its business, shareholder received the funds in an indirect way.

FCA held subsection 84(2) broad enough to apply, deem payment to be a dividend.

Relevant for pipeline transactions

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The result was that Dr. MacDonald was considered to have a deemed dividend rather than a capital gain. The reason is that the court determined that subsection 84(2) was broad enough to apply to deem the proceeds received by Dr. MacDonald to be a note. Subsection 84(2) states that where funds or property of a corporation resident in Canada have been distributed or otherwise appropriated in any manner whatsoever to or for the benefit of a shareholder on the windup, discontinuance or reorganization of its business, a dividend results. The dividend is the amount of the fair market value received less the paid up capital reduced on the shares.

In Dr. MacDonald's case there was no reduction of paid up capital, so the full amount was considered to be a dividend.

Here the professional corporation was wound up, discontinued its business, and the shareholder received the funds in an indirect way.

The Federal Court of Appeal, reversing the decision of the Tax Court, held that subsection 84(2) was broad enough to apply in this situation.

This is of course relevant for pipeline type transactions because if subsection 84(2) results in a deemed dividend, the transaction will not work as intended.

Avoiding Dividend Treatment

How Broad is MacDonald Principle?

If Opco business continued, not wound up, does rule apply?

Can ACB be extracted in general?

Surplus stripping not subject to GAAR if other anti-avoidance rules don't apply (per Gwartz decision). No inherent policy intent in Income Tax Act to prevent surplus stripping (specific rules apply or don't – 84.1, 55(2), 84(2))

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It is difficult to know how broad the MacDonald principle actually is. For example, did it matter that the corporation was a professional corporation, which was deregistered? Is this a reorganization of its business? Did it matter that Dr. MacDonald had capital losses? It is hard to see how that would be relevant.

If a corporation carries on an active business and a pipeline type transaction is done, but the business continues, one would imagine that section 84.1 would not apply.

So one would think that as a general point, arm's length adjusted cost base can be extracted in a pipeline type transaction, with a payment of corporate funds.

The case law under the general anti avoidance rule has concluded that surplus stripping is not subject to GAAR , and there is no specific policy intent against surplus stripping in the Income Tax Act, if various sections directed to surplus stripping do not apply. In other words, the sections which result in deemed dividend treatment represent a complete code in what will be re-characterized, and provided those sections are complied with, and not artificially avoided through technical arguments that frustrate their intent, then deemed dividend treatment will not apply.

Avoiding Dividend Treatment

CRA Positions

Although not based on MacDonald decision, CRA states no 84(2) challenge if:

a) The operating company remains a separate and distinct entity (i.e. is not wound up or amalgamated) for at least one year;
b) The operating company continues to carry on business in the same manner as it had.); and
c) The note is repaid on a progressive basis as opposed to all at once.

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CRA has taken a number of administrative positions with respect to the MacDonald decision. One of these positions deals with a pipeline transaction through an estate. Refer to the previous example of Denise.

CRA has said that provided the note has paid out over a period of three years, subsection 84(2) will not be applied. It is hard to see the basis for this three year requirement . Also, one does not know if it is necessary that Opco continue to carry on its business. Also, if Opco is an investment company which does not carry on a business other than the holding of investments, does this automatically exempt the transactions from the MacDonald principle?

All of this has given rise to a great deal of uncertainty.

The technical interpretations from CRA are referenced below .

2014-0526361R3	2015-0569891R3	2016-0677751R3
2014-0526431R3	2015-0588551R3	2016-0670871R3
2014-0540861R3	2015-0604851R3	2016-0675861R3
2014-0541261R3	2015-0606721R3	
2014-0545531R3	2015-0617601E5	
2014-0548621R3	2016-0646891R3	
2014-0552071R3	2015-0602831R3	
2014-0559481R3	2016-0629511R3	
2014-0563081R3	2016-0634371R3	

Avoiding Dividend Treatment

Subsection 120.4(4)

NAL capital gains realized by individual under 18 from private company shares (direct or via trust)

Doesn't matter if capital gains exemption claimed or not.

Subsection 120.4(4) and subsection 120.4(5) deal with the re-characterization of capital gain realized by a person under the age 18 in respect of a sale of shares of a private company to a non-arm's length person. For purposes of this rule it does not matter if the capital gains exemption is claimed or not.

Under the rule, the entire capital gain is deemed to be an ineligible dividend, and then subject to the kiddie tax at the top tax rate.

Suppose that the capital gains exemption is claimed, unaware that this rule applies the capital gain is believed to be exempt of tax. However, the end result is that capital gain is fully taxable as a dividend resulting in tax at 47%. This is a very catastrophic result.

Avoiding Dividend Treatment

Crystallization

Lee Family Trust owns shares of LCo.

LCo is SBC but will soon cease to qualify due to international subsidiary expansion.

Gain is crystalized via sale to Holdco

Gain allocated to beneficiaries under age 18 by promissory note

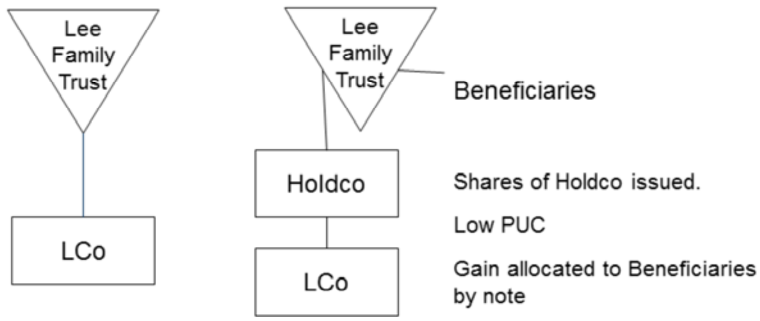
One of the common ways in which the capital gains exemption is realized in a non-arm's length transaction is through a crystallization.

In this example, the Lee Family Trust owns shares of LCo.

LCo is a small business corporation but will soon cease to qualify due to establishment of an international subsidiary which will grow in value over time. As a result, the suggestion is to crystalize the capital gains exemption now.

The crystallization is done by the trust through a transfer of shares to Holdco, creating a capital gain in the trust. The capital gain is allocated to beneficiaries some of whom are under the age of 18 by issuance of a promissory note. (In this circumstance, one should note CRA's views on the allocation of "phantom income" being income which is deemed to arise but which does not actually arise in the transaction. CRA has taken the position that phantom income can be paid out to a beneficiary but there are certain requirements. A discussion of these requirements is beyond the scope of these materials.)

Avoiding Dividend Treatment



Result – Gain (100%) deemed ineligible dividend taxed at top rate 47% to beneficiary because TOSI applies.

- Very harsh results

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These diagrams illustrate the crystallization transaction with the establishment of Holdco. The shares of Holdco have a low paid up capital a gain is deliberately triggered and then allocated to the beneficiaries by issuing promissory notes from the trust to the beneficiary.

As discussed before, a gain is re-characterized as an ineligible dividend, taxed at the top tax rate of 47%.

Avoiding Dividend Treatment

When Does Rule Not Apply

Elect gain on private corporation going public (section 48.1)

Person becomes non-resident

21 year rule applies to trust

Trust becomes non-resident

Reason – no transfer to non-arm's length person

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The rule applies only where there has been a transaction involving a transfer of the shares to a person with whom the specified individual did not deal at arm's length. If the shares have not been transferred, then it is arguable that the provision does not apply.

There are four circumstances where a capital gain could be realized without there being a transaction.

These are:

1. Where a private corporation goes public, an election can be made under section 48.1 for a capital gain to be triggered.
2. Where an individual becomes a non-resident, there is a deemed disposition on departure, but not a transaction.
3. Where the 21 year rule would apply to the trust, there is also a deemed disposition.
4. Where the trust itself becomes non-resident. In this case there is a deemed disposition of the assets of the trust in departure.

If there is a wish to trigger the capital gains exemption in a crystallization that involves minor children, one might consider having the trust become non resident.

Avoiding Dividend Treatment

Conclusions

Several ways for deemed dividend to apply, many are unexpected especially via 84.1

Harsh result made worse by TOSI rules (top tax rate)

Get help if you need it

Complexity is beyond what many CPAs can handle

Don't try to be a hero and become a victim of a lawsuit

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As the slides have illustrated , there are many ways in which a deemed dividend can result, and a number of circumstances are unexpected and surprising. This is especially true of section 84.1.

The result is a harsh result, made worse by the TOSI rules if they apply.

Persons advising in this area should get help if it is needed. The complexity of these matters is beyond what many CPAs will be capable of handling, and section 84.1 is the most common reason for CPAs being sued. Caution is very much advised.