TAX FOR THE Owner-Manager

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CALU CRA-Finance Roundtable Clarification of Bill C-208 Amendments

At the recent 2022 CALU CRA-Finance Roundtable (May 2022), question 3 (which consisted of four questions) provided some much-needed clarification of certain ambiguities in the Bill C-208 legislation—clarification that has since been published as CRA document no. 2022-0928721C6 (May 3, 2022). The bill was intended to provide relief to intergenerational business succession planning that was adversely affected by, among other provisions, section 84.1 of the ITA.

In very general terms, section 84.1 applies when a taxpayer resident in Canada (other than a corporation) disposes of shares of a corporation resident in Canada ("the subject corporation") that are capital property of the taxpayer ("subject shares") to another corporation ("the purchaser corporation") with which the taxpayer does not deal at arm's length, and, immediately after the disposition, the subject corporation would be connected with the purchaser corporation (within the meaning assigned by subsection 186(4) of the ITA).

This provision created a longstanding succession problem for family businesses because related persons are deemed not to deal at arm's length. As a result, a deemed dividend could arise if a taxpayer sold the shares in such circumstances for cash or a promissory note, meaning that internal corporate funds could not be used to finance buyouts. These types of buyouts were, however, feasible with an arm's-length purchaser.

Bill C-208 was designed to ameliorate this inequity by amending section 84.1 with the addition of paragraph 84.1(2)(e), which provides, among other things, that if the "subject shares" are shares of a qualified small business corporation or are shares of a family farm or fishing corporation, then the taxpayer and the purchaser corporation are deemed to be dealing at arm's length if the purchaser corporation is controlled by one or more children or grandchildren of the taxpayer who are 18 years of age or older.

This broad-based relief was subject to two potential limitations. The first is in paragraph 84.1(2.3)(a), which provides, among other things, that if, otherwise than by reason of death, the purchaser corporation disposes of the subject shares within 60 months of their purchase, paragraph 84.1(2)(e) is deemed never to have applied, and the taxpayer is deemed to have disposed of the subject shares to the person that acquired them (that is, not to the initial purchaser corporation).

The second limitation is in paragraph 84.1(2.3)(b), which ostensibly provides for a reduction in the capital gains deduction as the taxable capital employed in Canada by the subject corporation increases beyond a certain threshold.

Paragraph 84.1(2.3)(a) and Dispositions Within 60 Months

Questions 3.1 and 3.2 dealt with paragraph 84.1(2.3)(a) and the effect of dispositions of the subject shares by the purchaser corporation within 60 months of their disposal by the taxpayer. Commenting on the "by reason of death" exclusion, the CRA stated that since the words "by reason of" are not defined in the ITA, the CRA would look to the ordinary meaning of the phrase for guidance, and it concluded that a causal link between the death and the subsequent share disposition by the purchaser corporation would be required in order to rely on this exception.

Questions 3.1 and 3.2 addressed two scenarios. In the first scenario, the taxpayer ("the vendor") disposing of the subject shares dies within the 60-month period, and the purchaser corporation controlled by the vendor's child ("the child") then sells the shares to an arm's-length purchaser corporation. The second scenario dealt with the death of the child whose estate causes the subject shares to be sold back to the vendor.

With respect to the first scenario, the CRA stated that a determination of whether the "by reason of death" exception applied could be made only upon a review of all of the facts and circumstances. However, the CRA also stated that if the death of an individual (in this case, the vendor) made it impractical or difficult to continue the current ownership, then the "by reason of death" exception could apply to the first scenario.

With respect to the second scenario, the CRA was also prepared to accept that the disposition was "by reason of death." The CRA also commented on the consequences that would arise in each scenario if the "by reason of death" exception did not apply. The CRA confirmed that the methodology for looking at a transfer not exempted "by reason of death" was to apply section 84.1 as if the transfer had been made by the vendor directly to the ultimate purchaser, and it stated that section 84.1 did not apply to the original transfer from the vendor to the purchasing corporation. In the first scenario, the transfer would be to an arm's-length purchaser, and therefore subsection 84.1 would not apply. In the second scenario, too, the transfer would be back to the vendor, and, accordingly, section 84.1 would not apply.

Paragraph 84.1(2.3)(b): Taxable Capital Clawback

In question 3.3, the CRA confirmed that paragraph 84.1(2.3)(b), which appears designed to reduce the capital gains deduction on the basis of taxable capital employed in Canada but is drafted to apply only for the purposes of paragraph 84.1(2)(e), does not apply to reduce a taxpayer's capital gains deduction. Accordingly, a transfer that would otherwise benefit from the relief provided by Bill C-208 would not be precluded from benefiting from that relief solely because taxable capital employed in Canada exceeded the threshold provided for in the provision in question.

Paragraph 84.1(2.3)(c): Valuation and Affidavit

Finally, in question 3.4, the CRA addressed paragraph 84.1(2.3)(c), which requires the taxpayer to provide the minister with an independent assessment of the fair market value of the subject shares and an affidavit signed by the taxpayer and a third party attesting to the disposal of the shares. The CRA noted that guidance on these documentary requirements had been provided on its website ("Affidavits and Valuations for the Transfer of a Small Business, Family Farm or Fishing Corporation (Bill C-208)") and that these requirements are integral to the application of paragraph 84.1(2)(e), and it specifically stated that these requirements must be satisfied for that paragraph to apply. Advisers should pay close attention to the requirements set out on the CRA website, which appears to include more information than is explicitly set out in the legislation.

Conclusion

The recent CALU round table highlighted some of the defects in the legislative scheme adopted by Bill C-208, but it offers some welcome clarifications that may provide taxpayers with more certainty when applying these provisions. The Department of Finance announced that it plans to bring forward additional legislative amendments that would honour the spirit of Bill C-208 while safeguarding against unintended tax avoidance. The 2022 federal budget announced a consultation process on this matter and indicated that legislation to address these concerns may be introduced in the fall of 2022. Given the relatively wide berth provided by the existing legislation, tax advisers may want to carry out transactions under the current regime before new legislation is introduced, which, although it is likely to be sounder from a drafting perspective, may prove to be less generous to taxpayers.

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