INTER-GENERATIONAL TRANSFERS OF BUSINESS/ SURPLUS STRIPPING

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1. INTRODUCTION[1]

Section 84.1 of the *Income Tax Act*[2] triggers a deemed dividend upon certain non-arm's length share transfers. It is an anti-surplus stripping rule. The non-arm's length nature of an intergenerational share transfer naturally falls into its terms. The problematic application of this rule to the transfer of a business from one family member to another has long been recognized. Indeed it was the unintended application of section 84.1 to a family business restructuring in *Juliar v. Attorney General of Canada*[3] which led to the recognition of rectification as a judicial remedy to correct tax mistakes. The question which has been put forward is how this rule could be amended to facilitate "genuine" intergenerational transfers while still addressing surplus stripping.

In the March 22, 2017 Federal Budget, the government stated that it would "consider whether there are features of the current income tax system that have an inappropriate, adverse impact on genuine business transactions involving family members".[4] Then, on July 18, 2017, the Department of Finance proposed amendments to section 84.1 to address what it perceived to be inappropriate conversion of corporate surplus into capital gains. The 2017 Consultation Paper recognized the tension between the policy concern of surplus stripping versus family business transfer:[5]

> "Although it has been suggested that a genuine intergenerational transfer of shares of a small business corporation to an adult child's corporation should be treated the same as a sale to an arm's length corporation, a major policy concern is distinguishing a genuine intergenerational transfer from a tax avoidance transaction, . . . , undertaken among family members. The hallmarks that ensure 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."

There was significant critical commentary.[6] The particular July 18, 2017 proposal was subsequently withdrawn and again, there was specific recognition that the proposals "could result in several unintended consequences, such as in respect of taxation upon death and potential challenges with intergenerational transfers of businesses".[7]

The concern has continued to be articulated. Witness the 2019 Federal Budget materials which stated:[8]

> "The Government understands the importance Canadian farmers, fishers and other business owners place on being able to pass their businesses on to their children. The Government will continue its outreach to farmers, fishers and other business owners throughout 2019 to develop new proposals to better accommodate intergenerational transfers of businesses while protecting the integrity and fairness of the tax system."

To date, no relieving provisions have been suggested although Quebec has previously enacted its own limited relief.[9] The Quebec rules are discussed below.

This paper sets out a framework of a relieving proposal for consideration. This paper will not attempt a detailed analysis of surplus stripping and related jurisprudence. There is excellent literature on surplus stripping to which the interested reader is directed.[10]

Although the 2017 Consultation Paper and the title of this paper refer to "intergenerational" transfers, our focus has been on the broader range of "interfamily" transfers. For example, sibling to sibling is not "intergenerational" but is "interfamily". References herein to "intergenerational" may be read to mean "interfamily" where the context permits.

2. THE INTERGENERATIONAL TRANSFER PROBLEM

2.1 <u>Description of Surplus Stripping</u>

Understanding the problem requires context and a comparison of alternatives. Context requires an understanding of surplus stripping. Although the general concept seems relatively easy to explain and understand, it is not so easy to define with precision, in the context of Canada's current tax system. Surplus stripping has been variously described as:

- "choosing to realize the economic value of such surplus through a transaction characterized as a sale of shares that gives rise to a capital gain, rather than a distribution from the corporation that is taxed as a dividend"[11]

- "the substitution of a capital gain for a taxable dividend"[12]

- "the removal of funds from a corporation without payment of the amount of tax that the Department of National Revenue thinks should have been paid"[13]

and in the Carter Commission report as: "a tax-free distribution from a continuing business which, if made in the normal manner, would have been a taxable dividend. To this end, various schemes were contrived or arrangements entered into in such a way that the shareholders would receive in non-taxable form what were in effect distributions of income".[14] The concept of surplus stripping has evolved over time too with legislative change. While surplus stripping at the time of the Carter Commission may have involved receipt of capital gains (then not subject to tax) rather than a dividend, the post tax reform concern became access to the V-Day increment and the difference in taxation of dividends to other amounts.

The basic premise underlying surplus stripping policy is that distributions from a corporation to its shareholders "should" be treated as dividends for tax purposes, so that attempts to directly or indirectly receive (or be put into a position to receive) such distributions should be treated (*i.e.*, taxed) similarly as dividends. But a distribution could be considered received on account of capital. For example, an amount received from a corporation on a paid-up capital reduction of shares is effectively treated as capital. Also, a share sale to a third party could be regarded as an indirect distribution, or at least a realization, on account of capital. The dividend versus capital distinction is important to the extent that taxation of dividends differs from taxation of amounts received on account of capital. It is trite to say that the ITA legislates different taxation where a corporate distribution is a dividend in the hands of the recipient versus the realization of corporate value by a shareholder as a capital gain.

It is also important to keep in mind that Canada's tax system is premised on the integration of personal and corporate taxes for Canadian resident individuals and corporations. Integration has been said to be aspirational. It attempts to ensure that the total combined tax on corporate income is the same whether earned directly by an individual or through a corporation. In theory, integration works in the context of a particular item of income or gain realized by a corporation which is immediately distributed where the distribution matches the source of income. But integration does not work (meaning that the overall tax rate whether earned directly by an individual or through a corporation is not equal) for a host of reasons including:

- Personal and corporate rates may change from year to year, yet the gross-up and dividend tax credit (which are intended to prevent double taxation of corporate income) may be premised on different rates. In addition, provincial changes (or lack thereof) may exacerbate the issue.

- Corporate level deferral may effectively promote delay in distribution.

- Dividends (whether actual or deemed) may not match the timing of income realization or gain recognition by the corporation and but for recent changes to introduce two refundable tax accounts, a corporation could generally pay an eligible dividend to trigger a refund of refundable tax.

- A corporate distribution does not necessarily match the source of income. For example, a corporate attribute, such as capital dividend account, could be distributed by the corporation using income from a source other than the gain realization transaction, *e.g.,* active business income.

Rules to prevent surplus stripping are often justified based on the premise of integration, *i.e.,* corporate earnings should be taxed as dividends else integration would fail. However, as pointed out above, the status of integration is in decline. Further it merits pointing out that an anti-avoidance rule which deems a shareholder to receive a dividend may over-correct because the amount which is deemed to be a dividend may be, in whole or part, based on unrealized corporate surplus (rather than undistributed corporate earnings). But it is now generally accepted, following the Supreme Court of Canada decision in *Copthorne*,[15] that there is no overarching policy in the ITA against surplus stripping. Thus we submit that the distribution or realization of corporate surplus as something other than a dividend should not be regarded as inherently abusive.

A shareholder may realize the benefit of corporate surplus by the act of selling his/her shares, thereby realizing a capital gain. This is a surplus strip and was so recognized by the Carter Commission.[16] This could be a "genuine" sale to a third party or a "genuine" sale to family. But the non-arm's length nature of family transfers may arguably facilitate what may be regarded as "inappropriate" strips, perhaps with focus on rate arbitrage or accessing the tax-free nature of any V-Day increment in the cost of shares or the lifetime capital gains deduction[17]. The challenge in any attempt to provide relief is differentiating between a "genuine" sale versus an "inappropriate" strip.

2.2 Founder wishes to sell to Child

Let us consider the simple case of Founder, a Canadian resident individual who is the sole shareholder of a successful Canadian-controlled private corporation carrying on an active business ("Opco"). Founder's shares of Opco have nominal ACB and nominal PUC. Founder wishes to transition out of the business and retire. But Founder needs retirement funds and therefore cannot simply gift his shares to Child. Founder's choices are:

- sell the shares of Opco to a third party; or
- transition Opco to his/her child ("Child"), who has slowly become active in the business, by way of share sale.

Assumptions:

- the shares of Opco constitute qualified small business corporation shares ("QSBC shares");
- Founder has not previously claimed any portion of the LCGD; and
- Child has no independent means and will require use of Opco's funds to pay the purchase price to Founder.

The transactions which could occur are as follows.

(a) Share sale to Third Party

Founder will realize a capital gain on the sale of Opco shares and may claim the LCGD.

(b) Share sale to Child's corporation ("Child Co")

In contrast to the share sale to third party, in this option, Founder will not be able to make use of his/her LCGD. If Founder claims the LCGD upon the sale of shares to Child Co and receives a promissory note, Founder will be deemed to receive a dividend rather than a capital gain. This results from the operation of paragraph 84.1(1)(b). Given the assumption that Founder's shares had nominal ACB[18] and PUC and further assuming the issuance of a promissory note in satisfaction of the purchase price, paragraph 84.1(1)(b) will deem the full amount of the purchase price to be a dividend. The comparison to the third party sale reveals two disadvantages being: (a) Founder's loss of the tax free portion from the LCGD; and (b) Founder's increased tax liability because the sales proceeds are deemed received as a dividend and therefore taxed accordingly.

(c) Share sale to Child

Similar to the share sale to third party, Founder will realize a capital gain on the sale of Opco shares and may claim the LCGD. Founder is not disadvantaged. However, Child will face additional cost in funding the purchase price. Additional tax-driven steps must be undertaken to achieve some efficiency. For example, if Child wishes to access corporate funds to pay the purchase price to Founder, Child could receive dividends from Opco and use the after-tax amount for payment. This is costly to Child. Child could transfer the purchased Opco shares to Child Co but Founder's claim of the LCGD results in "soft" ACB to Child pursuant to subparagraph 84.1(2)(a.1)(ii). Child will have "hard" ACB only to the extent of the purchase price in excess of the LCGD claimed by Founder. Therefore, if Child transfers the purchased Opco shares to Child Co, the non-share consideration which Child may receive will be limited by the "hard "ACB and therefore will be less than his/her total purchase price from Founder. If Child is not aware of the "soft" basis rule and takes back a promissory note from Child Co as the full consideration for the transfer of Opco shares, then Child will be deemed to receive a dividend equal to the "soft" basis.

In summary, Child may satisfy his/her purchase price obligation to Founder by transferring the acquired Opco shares to Child Co:

- Portion equal to Founder's claim of LCGD will require Child to receive dividends from Child Co and pay tax accordingly, using the after-tax amount to satisfy this portion of the purchase price obligation to Founder.

- Portion equal to balance of purchase price may be received by Child from Child Co tax free as payment on promissory note (non-share consideration).

In comparison to the share sale to third party, there is no change to Founder's tax consequences. However, it is clear that Child will suffer additional tax cost to use corporate funds for the payment of the purchase price equal to the "soft" ACB.

Both Founder's sale to Child Co and Founder's sale to Child result in disadvantages compared to the sale to third party, all as a result of section 84.1.

In the above scenarios, Child Co will inevitably be non-arm's length to Founder. Given the assumption that Founder has control, the transfer of Opco shares to Child Co will also result in Opco being connected with Child Co within the meaning assigned by subsection 186(4).[19] These are the prerequisites to the application of section 84.1 and the consequences to Founder depend on whether he receives share or non-share consideration. Notwithstanding a fair market value sale with fair market value consideration, Founder cannot receive high PUC shares because of paragraph 84.1(1)(a) so that the eventual liquidation of such shares by redemption or purchase for cancellation will result in a deemed dividend. If Founder receives a promissory note or other non-share consideration equal to the fair market value of the transferred Opco shares, Founder will be deemed to have received a dividend in such amount because of paragraph 84.1(1)(b). Neither of these consequences would occur on a sale of Opco shares to an arm's length purchaser.

The above provide the simplest of possible examples for an intergenerational transfer. Founder may not wish to transfer all equity to Child. Opco might be a two family company; whether two arm's length families or two siblings where neither family/sibling alone has control. Founder might have previously implemented an estate freeze or partial estate freeze so that one or more children already hold some or all of the common shares while Founder remains the holder of preferred (freeze) shares with voting control.

It is interesting to note that a number of the reported cases which are part of well-known section 84.1 jurisprudence involved family business transfers.

Juliar (2000) 50 OR (3d) 728 (CA) was the longstanding seminal rectification case before being overruled by *Fairmont Hotels*. The case involved two sisters who had been gifted shares of the family business holding company by their father. Each sister wanted to set up her own holding company for estate planning. They had a mistaken understanding regarding the adjusted cost base of shares received from their father.

Olsen 2002 FCA 3 is known for being the case which raised the question of whether subsection 186(2) applied for purpose of the "connected" requirement in section 84.1, which is now statutorily recognized by subsection 186(7). The case involved a father's transfer of QSBC shares of a corporation involved in the fishing business for cash to corporations whose shareholders were son/daughter/daughter-in-law.

Crean 2019 BCSC 146 is a recent rectification case where a brother who wanted to retire sold his shares of a corporation to his brother's Newco in consideration of a promissory note. This case aptly illustrated the tax consequences of the "Sale to Child Co" option described above and was rectified to the equivalent of the "Sale to Child" option above.

3. HISTORY AND "PURPOSE" OF SECTION 84.1

3.1 <u>1974-78 Deemed dividend on Repayment of Debt</u>

The present-day version of section 84.1 stems from 1977-78. The earlier version of section 84.1 (referred to herein as "Pre-78 Rules") applied to more limited circumstances and was applicable after November 18, 1974.[20] The Pre-78 Rules were connected with defined concepts of "debt limit'. "paid-up capital limit" and "paid-up capital deficiency". The apparent intention of the Pre-78 Rules was to limit the debt consideration issued by the purchaser corporation for the purchase of shares in the limited control-type circumstances set out therein (as described below) and further, limit the tax-free return of capital on a share redemption or reduction of paid-up capital based on the "paid-up capital limit". The "debt limit" [21] was generally the excess of the debt over the paid-up capital of the purchased shares. But consequences were deferred until payment on account of the debt (or debt substituted therefor) exceeded the "debt limit". This resulted in a deemed dividend at the time of payment. It was said that these rules precluded taxpayers from transferring shares to a controlled corporation to extract funds in a capital transaction in excess of paid-up capital.[22] The focus was not on the V-Day increment.

The Pre-78 Rules did not employ the same non-arm's length relationship requirement found in current section 84.1 as between the taxpayer disposing of shares and the purchaser corporation. Instead the relationship requirement was control, directly or indirectly in any manner whatever or ownership of shares representing more than 50% of the paid-up capital of all shares. In the case of the relationship with the equivalent of the purchaser corporation in current section 84,1, the Pre-78 Rules could also apply if the taxpayer held debt payable by such corporation at a time when shares representing more than 50% of its paid-up capital were beneficially owned by the taxpayer or persons related to the taxpayer. The relationship was tested as between the taxpayer and the equivalent of the subject corporation in current section 84.1 at the time of disposition[23], and as between the taxpayer and the equivalent of the purchaser corporation in current section 84.1 at any time before a payment was made on account of the debt.

The transfer of shares of a business corporation within the family and/or to the children could run afoul of the Pre-78 Rules, but if the specific prerequisites of the Pre-78 Rules were not met, there was a statutory backstop provided by former subsection 247(1), the express anti-surplus stripping rule which applied “in the opinion of the Minister”.[24] Former subsection 247(1) was broadly worded; the Minister had the discretionary power to include an amount in income (a taxable dividend in the case of an individual taxpayer) where a taxpayer received an amount as consideration for the sale of shares and “in the opinion of the Minister”, one of the purposes of the transaction or series was to effect a substantial reduction of, or disappearance of, the assets of a corporation in a manner that “the whole or any part of any tax that might otherwise have been or become payable under this Act in consequence of any distribution of income of a corporation has been or will be avoided”. Notwithstanding the breadth of the language, comfort was apparently taken from certain statements presented by the Assistant Director of the Rulings Division published in the Canadian Tax Journal which suggested restraint in the exercise of the Ministerial discretion in former subsection 247(1) in certain family situations. As can be seen from the below excerpt, this seemed to depend on the contribution of the “transferee” family member.[25]

> “Consider, for example, the first extreme where an individual sold shares of one wholly owned company to another company which he also wholly owned. This is the circumstance where it seemed clear that the Department might well invoke the avoidance provisions. Now vary this assumption to the extent that:
>
> (a) the purchasing company is equitably owned by the vendor's wife but he controls through voting preferred shares or otherwise;
>
> (b) the purchasing company is equitably owned by trusts for infant children or even unborn issue and the vendor controls as in (a);
>
> (c) the purchasing company is equitably owned by adult children who neither participate in the business nor contribute substantial capital, and vendor controls as in (a);
>
> (d) the purchasing company is equitably owned by adult children who actively participate in the business and/or contribute substantial capital and father may or may not retain control; and
>
> (e) the purchasing company is equitably owned by a brother, uncle or other relative who participates and contributes substantial capital and the vendor does not continue to control other than as a measure of security for the balance of the purchase price.

> In applying the provisions of subsection 138A(1), the Department has regarded the circumstances in (a), (b) and (c), where shares are sold to a wife, minor children or even adult children who neither participate nor contribute capital, as being in the nature of a surplus strip although (b) and (c) probably also have an estate-freeze purpose. The circumstances in (d) and (e) would probably not be so regarded."

The above scenarios would fit the non-arm's length relationship prerequisite in current section 84.1, but there is no relief or exception based on purpose (or lack thereof) of stripping or active contribution of the "transferee" family members.

3.2 1977-78 Amendments

When the modern version of section 84.1 was introduced in 1977-78[26], former subsection 247(1) remained but was later repealed with the enactment of the GAAR. This version of section 84.1 triggered deemed capital gain consequences. The focus of section 84.1 as amended in 1977-78 became extraction of the tax-free V-day increment, rather than the previous focus on "extraction" of funds at capital gains rates.[27] The rate differential between capital gains and dividends at the time had closed to approximately 8%. Stripping post-71 retained earnings as a capital gain did not seem to be a concern, where section 84.1 as amended did not apply.[28] In general terms, the rule as amended in 1977-78 provided for an ACB reduction of the consideration received (whether shares or debt) to the extent that ACB to the taxpayer of the subject shares exceeded paid-up capital. As a result, the deemed capital gain consequence was triggered on payment of the debt or redemption of the share consideration.

The relationship requirement between the taxpayer and the purchaser corporation broadened from the control-type situations previously applicable to non-arm's length as it is today, including a group of six persons deemed non-arm's length rule similar to current paragraph 84.1(2)(b). Also similar to today, the subject corporation was required to be connected with the purchaser corporation. However, the excess of non-share consideration over the paid-up capital of transferred shares remained a capital gain to the taxpayer. Today, paragraph 84.1(1)(b) would trigger an immediate deemed dividend equal to the excess of non-share consideration over the greater of paid-up capital of the subject shares and "hard" basis.

3.3 1985 Amendment

The introduction of the LCGD in 1985 led to changes to section 84.1.[29] Notably, rather than triggering a deemed gain, section 84.1 was amended to trigger a deemed dividend. Further, LCGD claimed by the taxpayer transferring the shares to the purchaser corporation or claimed by a non-arm's length person resulted in "soft" ACB, similar to the treatment of V-Day increment.

3.4 Purpose

It has been said that the purpose of section 84.1 is "to prevent taxpayers from performing transactions whose goal is to strip a corporation of its surpluses tax-free through the use of a tax-exempt margin or a capital gain exemption".[30] The Federal Court of Appeal in *Pomerleau*[31] echoed the foregoing:

> "What then is the object, spirit and purpose of section 84.1? Based on the above analysis, the object, spirit and purpose of this provision is to prevent amounts that have not been taxed from being used to remove corporate surplus on a tax-free basis. Subsection 84.1(2) achieves this goal by focusing on amounts which although reflected in the ACB of the subject shares were not derived from tax paid funds, and excluding them from the computation of the paid-up capital of the new shares. To this end, subparagraph 84.1(2)(*a.1*)(ii) requires looking beyond the ACB of the subject shares—or shares for which they were substituted -- and asking whether it is made up of amounts on which tax has not been paid."

Admittedly, the LCGD and the V-Day increment both represent portions of capital gains that can be free from tax. Thus, in a sense, it seems easier to identify an abuse, if corporate surplus is effectively distributed (*i.e.,* "converted into") capital gains that benefit from these exemptions. Notably however, this is only perceived as abusive, where the conversion occurs in a non-arm's length scenario. In an arm's length scenario, this is accepted realization of the economic benefit of the shares.

It may also be noted that in *Pomerleau,* the taxpayer argued that the transactions in issue had not misused or abused section 84.1 because that section was not intended to apply to the intergenerational transfer of a family business. Although the argument was not successful, the Federal Court of Appeal expressly noted the punitive effect.[32]

4. POSSIBLE APPROACHES TO FACILITATE INTERGENERATIONAL TRANSFERS

4.1 <u>Some General Comments</u>

Section 84.1 has been referred to as a notorious trap for the unwary taxpayer and his/her professional advisor. This derives from the section's broad wording, yet the abuse which the section seeks to prevent is relatively narrow, *i.e.*, extraction of the LCGD and V-Day increment. Consideration could be given to changes to section 84.1 such as causing the deemed dividend result to apply only where (and to the extent that) the taxpayer's gain on the transfer of the subject shares to the purchaser corporation is sheltered by LCGD claimed or V-Day increment in the shares. Similarly, where a previous non-arm's length person claimed the LCGD or V-Day increment which is embedded in the basis of shares, the current deemed dividend result could apply only to the extent of such embedded basis. At present, additional tax planned steps are needed to address the above (see discussion in "Share sale to Child"); hence there is a trap for those without proper advice.

Current high effective personal dividend rates, compared to capital gain rates produce an incentive to access corporate surplus as a capital gain rather than as dividends. A reduction in the rate difference would reduce this incentive and would also reduce the penalty effect of a section 84.1 deemed dividend. This does not however address the comparative access to the LCGD and V-Day increment in a third party sale versus an intergenerational family transfer.

Similarly a comprehensive reform approach which might define and track corporate surplus, attribute same to a shareholder, define when and how such surplus might be taxed on direct, indirect or notional distributions might be considered with reference to all shareholders and corporations. This would not be limited to the private corporation/family business. The spectre of complexity and onerous compliance rises.

4.2 "Hallmark" Approaches – General Considerations

At first blush, it seems absolutely correct from a policy perspective that a taxpayer should not be able to use tax exemptions to extract funds tax-free from a corporation. Therefore, the benefit of the LCGD and V-Day increment should not be accessible in this manner.

However, in an arm's length sale, a taxpayer is indirectly doing so. The share sale enables the taxpayer to realize the value of the corporation (*i.e.,* corporate surplus) and although the payment comes directly from the purchaser on closing, it may be considered indirectly distributed from the corporation[33]. The taxpayer could sell all or part of his/her shares to the arm's length purchaser; a complete exit is not required as a prerequisite.

That is, even though the transaction might be described as one form of "surplus stripping" (in a broad sense), provided that the transaction is completed at arm's length[34] and is not part of a distribution that would be "caught" by subsection 84(2)[35], our current Canadian tax system nevertheless permits capital gain treatment for the vendor. The case law regarding the application of section 84.1 to an acquisition of subject corporation shares by a purchaser corporation that is ostensibly dealing at "arm's length" with the vendor has generally focused on the question as to whether the parties were acting in concert without separate interests, rendering them "factually non-arm's length" with respect to the transaction. In effect, the question is typically whether the purchaser corporation has a "real" economic motivation to complete the transaction, or instead whether it is a "mere facilitator" whose main role is to assist the vendor in extracting funds from the subject corporation indirectly (perhaps in exchange for a "fee")[36].

The 2017 Consultation Paper recognized that any actions taken to reduce the potential tax disincentive to "genuine" business transfers among family members would need to ensure that "abusive" transactions are not thereby permitted. The Department of Finance suggested that it might be possible to, in effect, describe situations in which a transfer of shares among family members could be considered sufficiently similar to an arm's length transfer that it would not be considered unreasonable to allow the same beneficial income tax treatment. In this regard, it raised the concept of defining the "hallmarks" of a "genuine" business transfer to a new owner, being features that could be expected to result from such a transfer, and using these hallmarks as the basis of tests or conditions for access to any relieving measures. Although this approach is perhaps logical in principle, the obvious challenge is whether in fact such hallmarks exist and, if so, what they are.

The four broad hallmark factors that the 2017 Consultation Paper suggested a "genuine" business transfer to a new owner would "generally include" appear to have been influenced by United States tax rules that rely on similar criteria for certain purposes. We discuss these rules below in concept, and the general context in which they can apply. Although it can be useful to look at the experience of other jurisdictions, caution is necessary since the differences between taxation systems will often mean that a solution that "works" or that is otherwise appropriate for one does not or is not for the other.

More interestingly, despite Quebec having introduced earlier in 2016 details of their own attempt at addressing this very matter[37], the 2017 Consultation Paper does not specifically refer to the Quebec approach and the "conditions" identified for that purpose. Although the Quebec approach has been criticized as being unduly complicated and the potential relief limited, we believe it is instructive to review the rules to see what lessons can be learned.

More generally, the suggested hallmarks in the 2017 Consultation Paper were themselves criticized in many responses to the related consultation, including submissions from the Joint Committee[38] and CALU[39]. We review and comment below on the alternative approach suggested in the CALU submission.

4.3 U.S. Hallmark Approach

Before reviewing the specific U.S. hallmark factors, it is important to consider the context in which the U.S. tax rules addressing family business transfers operate[40].

In general, non-dividend distributions from a corporation to a shareholder are treated as a dividend, for U.S. income tax purposes, to the extent of the corporation's undistributed "earnings and profits" (or "E&P")[41], with amounts in excess of this reducing the tax basis of the shareholder's stock (which can result in capital gain treatment if such amounts exceed basis). The U.S. does not have a corporate "paid-up capital" tracking concept that would allow a shareholder to receive a recovery of tax basis prior to this deemed dividend treatment, to the extent that the corporation still has undistributed realized tax surplus on hand[42].

In the context of share redemptions[43], various exceptions to the deemed dividend treatment are provided. Conceptually, redemptions that more closely resemble a sale of shares to an unrelated third party can qualify for "exchange treatment" (i.e. as if the redemption were a "sale", with basis recovery and capital gain/loss treatment[44]). Other redemptions (i.e. those more closely resembling dividend distributions) are, therefore, subject to the "E&P first" deemed dividend treatment.

In particular, a share redemption can qualify for "exchange treatment" if the redemption is "in complete redemption of all the stock of the corporation owned by the shareholder.[45]" Complicated attribution rules are provided that, for purposes of this test, impute ownership of shares between family members (and between business entities and their beneficial owners, including between a corporation and a holder of options to acquire shares of the corporation)[46]. Exchange treatment under this "complete termination of interest" test requires that the shareholder not have any actual or "imputed" ownership of shares of the corporation following the redemption[47]. The extensive family member attribution scheme would, therefore, essentially rule out the application of exchange treatment where a family member (or related entity) continues to hold shares of the corporation, even if the redemption is intended to be a "genuine" method of indirectly transferring ownership between family members[48].

Absent a relieving rule, U.S. families would face a "tax penalty" on attempts to transfer corporate businesses between family members similar to that faced by Canadians. In both cases, individuals could obtain capital gain ("exchange") treatment by transferring shares directly to other individual family members, but the acquiring family member could be restricted from accessing corporate property to help fund the acquisition without having such distributions taxed as dividends[49].

To allow access to the exchange treatment in situations involving ongoing family member participation, therefore, the U.S. rules permit the redeeming shareholder to elect to have the family member attribution rules[50] waived provided certain conditions are met[51]. These conditions include the following:

- The shareholder must file an undertaking with the Internal Revenue Service (the "IRS") in which he or she agrees (i) to have no interest in the corporation immediately after the redemption other than as a creditor[52], and (ii) not to acquire any interest in the corporation during the 10-year period after the redemption. Failure to meet these tests then allows the IRS to re-open the shareholder's tax return for the year of redemption (i.e. to assess dividend treatment, as appropriate, rather than exchange treatment).

- The waiver doesn't apply if the shareholder continues as or becomes an officer, director or employee of the corporation during the 10-year period following the redemption. In effect, these positions are treated as a prohibited "interest" in the corporation that cannot be retained.

- The waiver doesn't apply if the shareholder either acquired any shares from, or transferred any shares to, a family member within 10 years prior to the redemption (unless the transfer was not done to avoid tax, or unless the shares transferred to another family member are redeemed as part of the same redemption transaction).

Accordingly, the conditions seek to ensure that the redeeming shareholder has in fact made a "complete exit" from the corporation, retaining no interests (either as a shareholder or employee) that could allow for continued participation in the economics of the corporate business following the redemption. The final condition listed above is intended to ensure that this concept is not abused by, for example, arranging for a transfer of shares to a family member as a preliminary step, so that those shares could be subsequently redeemed on the "exit" of that family member (who in fact might have only recently "entered" in the preliminary step)[53].

In this sense, therefore, the conditions seek to mirror the basic U.S. rules that require the redeeming shareholder to have no ongoing direct or indirect shareholdings in the corporation for exchange treatment to be achieved. In contrast, the rules in section 84.1 with which we are concerned are simply not applicable where the acquiring corporation deals at arm's length with the vendor individual. No limitations on ongoing "interests" in the transferred corporation (or the purchaser), whether as shareholder or employee, are imposed. Accordingly, although the U.S. hallmark conditions allowing access to capital gain treatment for family business transfers achieved through share redemptions could be considered a reasonable approach to ensuring that such transfers are "sufficiently similar" to arm's length transactions that would otherwise qualify for the beneficial U.S. tax treatment, the conditions would arguably be inappropriate (i.e. overly restrictive) in the Canadian context that we are considering.

4.4 <u>Quebec Approach</u>

Quebec's intention to provide some relief from the rules in the *Quebec Taxation Act* [54]("QTA") that are the equivalent to federal section 84.1 was first announced in the 2015-2016 Quebec Budget. After public consultations undertaken over the following year, specific details were announced in the 2016-2017 Quebec Budget[55].

The Quebec changes sought to achieve an approach that would "reduce the undesirable effects of the integrity rules [i.e. section 84.1] aimed at preventing surplus stripping in conjunction with a transfer of a family business" in a manner that would be "equally acceptable from the viewpoint of the tax system's integrity, neutrality or fairness." The nature of the relief that could be provided under the Quebec changes, without seriously jeopardizing the general harmonization of rules and concepts between the ITA and the QTA, was necessarily limited however. Accordingly, the "easing" allowed is limited to treating as a capital gain an amount that would otherwise be deemed to be a dividend under QTA sections 517.1 – 517.3 (or such lesser amount deemed to be a dividend for federal tax purposes under section 84.1), and no modification to the paid-up capital adjustment rules (for share consideration) or the "soft basis" rules are provided[56].

More specifically, where "eligible shares" are disposed of by an individual (other than a trust) in connection with an "eligible business transfer" of the individual and a deemed dividend would otherwise result for purposes of the QTA, the lesser of that deemed dividend and the amount deemed to be a dividend for purposes of the ITA is deemed instead to be a capital gain from the disposition, to the extent of the amount designated by the individual, but in any event, not to exceed the individual's remaining capital gain exemption that could be claimed for the year in respect of the deemed gain[57].

"Eligible shares" are defined[58] to be shares that qualify at the time of the disposition as either QSBC shares or shares of a family farm or fishing corporation[59]. An "eligible business transfer" of an individual is defined[60] to mean a series of transactions (referred to here as the "Series") that includes the disposition of eligible shares of the individual to which the QTA version of section 84.1 applies, provided that six additional conditions are met in respect of the series. These conditions represent, in effect, the "hallmarks" that Quebec has identified.

Quebec had originally anticipated that qualification criteria would be developed and that an individual would be required to obtain a qualification certificate from an agency responsible for confirming that the disposition is carried out in compliance with the conditions. As a result of the consultation process, though, Quebec decided that it was preferable to select criteria "having an objective character, ideally based on easily determinable and verifiable factual elements, as opposed to more subjective criteria whose interpretation could be far too uncertain", such that the proposed qualification certificate process could be dispensed with. While we certainly concur with Quebec's description as to what would form an appropriate hallmark scheme, many of the detailed criteria arguably fail to achieve the desired characteristics of being simple and objectively verifiable.

The six criteria can be loosely summarized as follows. Note that some of the criteria focus on a particular business, as distinct from the "subject corporation" (within the meaning of section 84.1) itself, and some focus on subject corporation and purchaser corporation (or corporations in which they have a direct or indirect interest). This can make it somewhat difficult at times to interpret the overall ambit of the criteria. Furthermore, there are various exceptions and qualifications that frustrate attempts to accurately describe the criteria in simple terms[61].

1. The individual or the spouse of the individual must have been "actively engaged" in a business carried on by the subject corporation, or a corporation in which it had a "substantial interest[62]" immediately before the disposition (referred to here as a "QSub"), during the 24-month period immediately preceding the disposition.

2. That active engagement in the business, or in certain businesses carried on by the purchaser corporation, ceases after the disposition.

3. Throughout the period (referred to here as the "testing period") beginning 30 days after the disposition and ending at the end of the Series, neither the individual nor the spouse of the individual has de jure control (or is part of a group having de jure control) of the subject corporation or a QSub.

4. Throughout the testing period, neither the individual nor the spouse of the individual holds, directly or indirectly, common shares of the subject corporation or a QSub.

5. Throughout the testing period, the aggregate of the fair market values ("FMV") of shares or debt of the subject corporation, a QSub or the purchaser corporation (referred to as a "corporation concerned") held directly or indirectly by the individual and any other individual benefiting from the Quebec relief in relation to a disposition of a share of the subject corporation as part of the Series, and by their respective spouses (a "residual financial interest"), doesn't exceed 80% (for family farm or fishing corporations) or 60% (for QSBC's) of the aggregate FMV, measured immediately before the beginning of the Series, of the shares of a corporation concerned (referred to here as the "opening FMV limit"). The terms and conditions of repayment or redemption of those residual financial interests are such that no later than 10 years after the disposition, the total FMV of those interests will be reduced to not more than 50% (for family farm or fishing corporations) or 30% (for QSBC's) of the opening FMV limit.

6. During the period beginning immediately after the disposition and ending at the end of the Series, at least one person (other than the individual) who holds, directly or indirectly, shares of the purchaser corporation, or that person's spouse, is actively engaged in a business carried on by the subject corporation or a QSub.

Taken together, these tests could be viewed as an attempt to describe situations in which an owner-manager "retires" (although not necessarily because of "old age") from an active business and divests ownership, and another owner-manager participates in the business thereafter. Although the tests could describe (and, therefore, apply for) many "family business transfer" situations, it is certainly far from a comprehensive description of such transfers and leaves out many situations that could, nevertheless, be considered "genuine". In particular, because the relief is limited to deemed dividends that would otherwise result from a disposition of shares to a purchaser corporation (i.e. the disposition must be one to which section 84.1 applies), LCGD (or V-day exemption) claims in respect of capital gains of an individual resulting from a deemed disposition on death are not eligible for relief. Since any LCGD and V-day exemption claimed become part of the ACB of the shares to the estate and any ultimate beneficiary, these parties will be prevented from obtaining any relief from the QTA version of section 84.1 on a subsequent transfer of the shares to a non-arm's length corporation (whether controlled by them, or by another family member in a situation that would otherwise qualify as an eligible business transfer in respect of that subsequent disposition). In this respect, therefore, the fact that the "easing" does not reduce the tax disincentive to retaining a small business within the family following the death of a shareholder is particularly glaring.

We will now look more closely at the six conditions, provide some examples to illustrate their application or non-application, and comment on related implications and potential problems with the conditions.

Conditions #1, 2 and 6: Active Engagement in the Business

The 24-month period of required "active engagement" immediately prior to the disposition is relieved where the individual or spouse was unable to be actively engaged in the business because of illness or disability (in which case the 24-month period is measured backwards from the date when that inability began). Where an individual dies, having met the activity test at that time, the individual's spouse is then deemed to have owned the shares and met the activity test for the 24-months following the individual's death, such that an inactive spouse who inherits shares can qualify for the relief on a subsequent transfer during that period. In this case, though, note that the relief is available only if the shares otherwise continue to qualify as QSBC shares at the date of the later disposition, and the benefit is limited to the spouse's own LCGD - any LCGD claimed by the individual in the terminal return is captured in the ACB of the shares to the spouse, and is thus ineligible under Quebec's rules[63]. It is not clear, though, why relief is not available in situations where an individual had been actively engaged during some earlier period. Individuals who have previously "retired" from the business but retained all or some of their equity ownership are simply not eligible.

More generally, it is not clear why being actively engaged in the business should be a requirement at all. Where a "small business corporation[64]" (an "SBC") is closely-held by members of a particular family[65], a desire to retain ownership of that SBC within the family should not be denied the tax treatment otherwise available for a disposition to a third-party merely because the particular shareholder was not previously "active" in the business, or because the shareholder fails to step away quickly enough following the sale. The hallmarks regarding activity appear to be focused more on determining whether the circumstances of the transfer are "worthy" of tax relief (in the sense of allowing a business in which a family member is "engaged" to be passed on to another family member that will continue the business) rather than whether the transfer itself is "genuine."

The reference to businesses carried on by a QSub allows relief to be provided in situations involving an inactive Holdco, but also illustrates an interesting difference in the required level of indirect "ownership" of the business in which the shareholder must be actively engaged.

Consider a situation where Mr. X owns 10.1%[66] of the shares of Opco. Arm's length parties own the remainder of the shares. Opco carries on a business in which Mr. X is actively engaged. Mr. X could sell all of his shares to Y Co, a corporation owned by his daughter, and (provided the other conditions are met[67]) qualify for the tax relief.

Alternatively, assume Mr. X holds his interest in Opco through a holding company, X Co. A sale of X Co to Y Co would not qualify for the relief unless X Co holds a substantial interest (i.e. at least 25% of the votes and value[68]) in Opco. Conversely, if Opco was owned 24.9% by X Co, and X Co itself carried on another business in which Mr. X was active, Mr. X could sell X Co to Y Co and qualify for the tax relief while remaining actively engaged in Opco's business, provided that Mr. X steps away from the X Co business in favour of his daughter. The relief would be available even where the value of the X Co shares was driven largely by its interest in the Opco business. It is not immediately obvious why there should be such distinctions in the tests[69].

The limitations on active engagement by the individual following the disposition do not apply in respect of a "transition period", provided that the engagement during this period "aims to encourage the transfer of knowledge" related to the business for the benefit of other persons actively engaged in the business[70]. It is also acceptable for the individual to become actively engaged in a business that is not a "same or similar business[71]" to one carried on prior to the disposition by the subject corporation or purchaser corporation or by any other corporation in which either corporation held a direct or indirect interest[72].

Although the criteria are intended to be "objective" and "easily verifiable", the "actively engaged" tests could introduce significant uncertainty and subjectivity. The concept of being "actively engaged" in a business, without further qualifiers, appears in the definition of "earned income" for RRSP purposes[73] in the context of a business carried on through a partnership. The CRA has interpreted the requirement in that context to mean a person

> "who is actively involved in the management and/or day to day activities of the business. The person would ordinarily be expected to contribute time, labour and attention to the business to a sufficient extent that such contributions would be determinant in the successful operation of the business.[74]"

It is not clear, though, that the "test" applied to distinguish a person who is actively carrying on a business as a partner from one who is only "passively" carrying on that business (to determine whether income from that business should be considered to have been "earned" by the person) should be the same test applied to determine the level of involvement of an individual in a business "carried on" by a corporation. The same interpretation, however, has been given by the CRA in the context of the farm or fishing property rules, which require an individual to have been "actively engaged on a regular and continuous basis" in the relevant farming or fishing business, and which business might be carried on by a corporation. It is not clear, though, what impact the lack of the modifying words "regular and continuous" would have on the interpretation of the condition for purposes of the hallmarks test. It is hard to see how an interpretation that the individual's engagement must be "determinant in the successful operation of the business" could square with an interpretation allowing for a mere "sporadic" level of activeness (as opposed to being "regular and continuous").

More recently, the Department of Finance technical notes for the definition of "excluded business" in the TOSI rules[75], which require that an individual be "actively engaged on a regular, continuous and substantial basis in the activities" of a business, noted that whether an individual is "actively engaged" in a business would depend on the "time, work and energy that the individual devotes to the business." CRA commentary has simply reiterated the technical notes, to the effect that "the more an individual's contributions are integral to the success of the business, the more substantial they would be.[76]" Arguably, then, the "determinant in the successful operation" phrase in the CRA's older interpretations is now captured in the "substantial" qualifier. "Actively engaged", by itself, then must be a lower standard. In the context of a business carried on by a corporation, could it be satisfied by (merely) acting as a director or officer? The uncertainty regarding the meaning of the phrase in the TOSI context led to the "safe harbor" test of working in the business an average of 20 hours per week (during the period in the year that the business is active)[77].

The lack of a clear standard as to how much activity would be required (and the extent to which, if at all, the activity must have more than a sporadic or fleeting character during a relevant period) means that in many cases a taxpayer could have difficulty demonstrating that either a particular degree of activity was, or was not, undertaken, as the case may be. That is, if the appropriate meaning of "active engagement" is one that requires a relatively high level of engagement, it will be more difficult to establish that involvement prior to the disposition, but easier to establish a lack of involvement thereafter – the opposite would be the case if a low level of engagement is sufficient. As a practical matter, it is not entirely obvious how one would "police" whether a supposedly retired entrepreneur has completely ceased providing advice or counsel to a family member, for example. The fact that an exception for a transitional knowledge transfer period is provided, but with no guidance regarding how long this might be allowed to continue, suggests that in practice the real requirement would be that the individual simply cease receiving more than modest compensation for his or her ongoing business involvement[78].

Condition #3 and 4: No Post-disposition de jure Control or Common Share Ownership

These conditions prohibit ongoing (during the testing period) de jure control and the holding "directly or indirectly" of common shares of the subject corporation or a QSub, unless the corporation in question does not carry on an active business or carries on an active business that is not a "same or similar business" to one carried on prior to the disposition by the subject corporation, the purchaser corporation, or by a corporation in which either one had a direct or indirect interest.

Interestingly, the rules don't seem to prohibit ongoing control of the purchasing corporation by the individual, provided that the purchasing corporation itself (or as part of a group) doesn't control the subject corporation or a QSub. For example, if Mr. X owns 40% of Opco and an unrelated Ms. Y owns 60%, it appears that Mr. X could sell his shares of Opco to a Child Co (a corporation established by one of his children) in exchange for voting preferred shares of Child Co (together with debt of Child Co, perhaps). Provided that Mr. X ceases his active engagement in Opco and his child becomes actively engaged (and provided that the value of Mr. X's investment in Child Co complies with the fifth condition) Mr. X could control and continue to control Child Co and still qualify for the tax relief.

Note, however, that it is somewhat unclear what is intended by the prohibition on the individual holding common shares of the subject corporation "indirectly" during the testing period. In the previous example, Mr. X holds preferred shares (and possibly debt) of Child Co, which in turns holds common shares of Opco. It doesn't seem that this should be considered "indirect" ownership of Opco common shares, or else it would appear that the individual could never receive and continue to hold any preferred shares or debt as consideration for the disposition, rendering the test in the fifth condition superfluous. Presumably, though, holding common shares of the purchaser corporation would be intended, in this situation, to be considered an indirect holding of subject corporation common shares[79].

In general, the rational for restricting all ongoing ownership of common shares of the subject corporation could be viewed as unduly restrictive. It is clearly not uncommon for an owner of a business to sell a 50% interest to an unrelated purchaser, for example (and to either continue to be active or not active, as the case may be, following the sale). There are similarly many "genuine" situations in which the owner of a business wishes to sell a 50% (or greater) interest to one or more other family members. Parents might want to bring in family members, including adult children, to help support the growth or expansion of the business and will often need to rely on particular expertise that these other members possess. Permitting ongoing common share ownership, however, makes it very difficult to guard against potential "abuse" of the relief, especially where multiple classes of common shares, each with discretionary dividend entitlements, might be employed. In this regard, a disposition of shares might not be "genuine" if the vendor individual in effect retains shares that might in practice confer the ability to enjoy significant ongoing equity participation following the sale.

The testing period involves a "series of transactions" concept, in an attempt to provide a "bright-line" test at the time of disposition while "policing" attempts to circumvent the intention of the tests through later actions completed in contemplation of the series[80]. Although some more obvious abusive arrangements could be prevented in this manner, it might be difficult in practice to distinguish circumstances in which a post-disposition "reinvestment" for new common shares, for example, might be completed "in contemplation of" a previous disposition and those in which it is not. It might be acceptable for a former vendor to reacquire shares if the purchaser encounters unexpected financial or health issues, perhaps. It is less clear whether, for example, an unanticipated business expansion or growth opportunity, for which new investment is required, might form part of a series. In both cases, the question might turn on whether the post-disposition event was truly "unexpected" or "unanticipated", but even if so, it might be difficult to prove to the satisfaction of an auditor or a court. On the practical side again, though, to the extent that the subsequent event happens after the statute-barred date for the individual's tax return for the taxation year of disposition, the question might be moot[81].

Condition #5: Limitations on Post-disposition Ownership of Residual Financial Interests

For purposes of this condition, the terms and conditions of a residual financial interest that is a share must provide that:

- the holder cannot have a retraction right during the 10-year period post-disposition, other than as required to comply with the required reduction in ownership by the end of that 10-year period,
- the share has a cumulative dividend entitlement at a rate not in excess of a reasonable market rate[82] (not to be based on a corporation's profitability),
- the share is redeemable by the corporation at any time, and
- the share is convertible only into shares meeting the above conditions or debt meeting the conditions described below.

Similarly, the terms and conditions of a residual financial interest that is a debt must provide that:

- the holder cannot demand repayment before the end of the 10-year period, other than as required to meet the required ownership reductions thresholds,

- the interest rate on the debt doesn't exceed a reasonable market rate[83] (not to be based on a corporation's profitability),

- the debt is repayable, with accrued interest, at any time by the corporation, and

- the debt is convertible only into debts meeting the above conditions or shares meeting the conditions described above.

For purposes of determining the FMV of a residual financial interest of an individual, certain specific "look-through" rules apply:

- the individual is deemed to hold shares or debt of a corporation concerned held directly or indirectly by a trust in which the individual or the individual's spouse has a beneficial interest,

- the individual is deemed to hold shares or debt of a corporation concerned held directly or indirectly by a trust, partnership or corporation of which the individual or spouse holds, directly or indirectly, a debt or share interest, and

- the above two rules will not result in more than one individual being required to include the same amount in the calculation of his or her residual financial interest in the corporation concerned[84].

For purposes of determining the FMVs under this condition, the FMV of a residual interest in, and the pre-Series FMV of a share of, a corporation concerned is ignored if that corporation does not carry on an active business, or only carries on an active business that is not a "same or similar business" to one carried on before the disposition by the subject corporation or the purchaser corporation, or by a corporation in which either had a direct or indirect interest. Finally, the end of the Series, for purposes of determining whether the "initial" 60%/80% residual interest FMV threshold has been met, is to be determined without reference to transactions that are repayment or redemptions of those residual interests.

Although it might initially seem that the general concept inherent in this fifth condition is fairly clear – limiting the value of ongoing share or debt investment in the purchaser corporation or subject corporation to less than 60% of the "starting share values", reducing to 30% within 10 years (or 80% and 50%, respectively, for family farm or fishing corporations) – the details make this the most complicated provision to apply. In fact, the wording of this condition appears to make it impossible to satisfy in many situations in which the individual retains anything but cash consideration 30 days after the disposition. This is because the look-through rules deem an individual to hold 100% of any financial interest actually held by a corporation in which the individual holds a financial interest.

For example, in a situation where an individual sells 100% of Opco common shares to a newly incorporated Child Co and the individual receives and continues to hold any shares or debt of Child Co, the individual is deemed to hold all of the Opco shares (i.e. 100%) that are actually held by Child

Co. As a result (assuming the FMV of shares in Child Co at the start of the Series was nil), the individual will have a FMV of its residual financial interests equal to at least 100% of the aggregate FMV of the Child Co and Opco shares at the start of the Series, and this will not decrease (unless the FMV of Opco itself decreases over time) even if the individual's direct financial interests in Child Co are reduced over time. Moreover, because the Opco shares are common shares, they will fail to meet the required terms and conditions for residual financial interests of the individual.

Accordingly, it is very difficult to make sense of how this condition is intended to be interpreted and applied. Taking into account an "indirect" holding of common shares of a corporation concerned as a residual financial interest of the individual or the individual's spouse seems to be at odds with the restriction in the fourth condition against their holding (directly or indirectly) common shares of the subject corporation or a QSub following the disposition and, as illustrated above, would in any event cause the fifth condition itself to be breached because the interest wouldn't satisfy the required "terms and conditions" requirements.

Ignoring all "indirect" holdings, however, could render the test ineffective in many cases. Consider, for example, a situation where Mr. X sells 100% of his Opco common shares worth $1 million to a Child Co in exchange for debt and preferred shares worth $1 million (Child holds 100% of the common shares of Child Co, but they have nominal value initially). Provided that Child Co remains a "pure" holdco that itself doesn't carry on an active business, the FMV of interests in Child Co are to be ignored for purposes of the FMV tests in this condition. Accordingly, unless at least some portion of the underlying FMV of the Opco common shares held by Child Co is somehow "imputed" to Mr. X, the FMV of his residual financial interests would be nil and he would satisfy the tests under this condition regardless as to whether his debt or preferred shares of Child Co are ever repaid or redeemed.

Directly imputing underlying common shares to Mr. X, even if only for the purpose of applying the ongoing FMV calculations, still seems problematic. The total FMV of all the shares of the subject corporation, any QSub, and the purchaser corporation at the start of the Series sets the (fixed) threshold against which the individual's ongoing residual financial interest FMV is measured. That ongoing FMV amount, though, would fluctuate (up or down) based on the underlying values of any common shares imputed to Mr. X, quite apart from whatever specific percentage interests in those common shares is considered to be retained from time-to-time by the individual for purposes of the ongoing calculations. Therefore, even if the value of the individual's direct interests in the purchaser corporation or any direct retained interest in the subject corporation or a QSub, are "fixed" amounts following the disposition (because the individual's ongoing financial interests in these entities are limited to fixed-value preferred shares and debt) and a bona fide plan is made to reduce these investments by the end of the 10-year period, it would generally not be possible at the time of the disposition to know what the required level of reduction would be. The tests do require that "indirect" holdings of interests in these entities be taken into account, though, or else the intent of the tests could be frustrated by the individual simply transferring retained interests into a new, wholly-owned holding company, for example.

In summary, it initially seems that it might be reasonable to require the individual and the individual's spouse to limit their direct or indirect retained investments in the subject corporation and any QSub, and to reduce those investments over time, to put the non-arm's length disposition transaction on a similar footing to "typical" sales to third parties (where it can be assumed that the vendor would typically expect to "cash out" at some point, even if not in full immediately). It is appropriate that the condition does not seek to require a complete divestiture, since genuine transactions with third parties often result in an ongoing retained interest. Even using simple examples, though, it quickly becomes very difficult to attempt to describe precisely how the amount of such direct or indirect retained interests should be measured, both in an absolute dollar and relative percentage sense, for purposes of setting out bright-line divestiture requirements[85]. The complexity only grows as more complicated corporate group structures are considered. Notwithstanding the very detailed rules set out in Quebec's fifth condition, the approach appears to badly miss the mark. It is far from obvious how the approach could be modified to achieve the condition's apparent intention without leaving room for intentional (or inadvertent) manipulation of the calculations.

Even if a workable approach to the calculations could be set out, the requirement to immediately reduce the individual's retained financial interests to a maximum 60% threshold could be problematic in many situations. Family members taking over the business might not have the personal financial "wherewithal" to fund the required "downpayment", and encouraging the business to take on significant new debt at the same time that the active participants in the business are changing might be an overly risky combination. In fact, the rules might simply encourage the "retiring" family member to lend the necessary funds directly to the acquiring family member(s)[86] – the rules have no restrictions regarding personal loans, even if secured by underlying financial interests in the subject corporation or purchaser corporation. An "indirect" investment represented by loans "through" a related individual does not itself appear to be prohibited[87]. Alternatively, if the initial value against which the value of retained interests is to be compared is determined prior to the beginning of the Series, and the Series includes "purification" transactions necessary to remove passive or redundant assets from the subject corporation so that it can qualify as an SBC at the time of the disposition, it might be easier for the vendor of a "surplus rich" company to meet the initial retained interest restrictions as compared to transactions involving companies that started with less "excess surplus". This seems a bit strange, somehow.

Finally, while requiring that retained interests be reduced by the end of a 10-year period following the disposition allows for a reasonably long time to accomplish the reductions, which could help to mitigate funding stresses on the business, it is not entirely clear what would happen should the required reductions fail to occur by the end of that period. By that time, it would generally be far too late to contemplate a reassessment of the disposition transaction[88]. If the terms and conditions regarding reductions to the retained financial interests were "reasonable" or *bona fide* in some sense, as determined at the time of the original disposition, the fact that subsequent economic results preclude the reductions, for example, shouldn't deny the original tax relief. It would likely be very difficult in practice, though, to determine with certainty whether a failure to comply with required reductions is in some sense intentional.

4.5 CALU's Suggested Hallmarks Approach

We discuss the CALU submission here, as one of the relatively few responses to the 2017 Consultation Paper that provided a reasonably comprehensive alternative approach of describing certain hallmark factors that could be used to distinguish business transfers among family members that are made for "bona fide non-tax purposes" from those that might have a predominant (and, hence "abusive") surplus stripping focus. The CALU approach attempts to address the concern that the hallmark factors suggested by the Department of Finance were too restrictive and unrepresentative of many typical "real world" private company sale transactions, while at the same time resisting use of some of the factors on which the Quebec approach relies.

The CALU approach contemplated an exception to the application of section 84.1, and a similar exception from the related "soft basis" restrictions that would otherwise apply where shares are sold directly to certain individual family members. The exception would apply to a share disposition where the following conditions are met:

- The vendor is at least a certain minimum age (e.g. age 50) or has significant health issues.
- The shares qualify as QSBC shares or shares of a family farm or fishing corporation for the vendor at the time of the disposition.
- Neither the vendor, nor any person affiliated[89] with the vendor, may (i) control the subject corporation after the disposition, or (ii) retains any shares of the subject corporation by three years following the disposition.
- The vendor's adult children, grandchildren, nephews/nieces and grandnephews/nieces ("qualified individuals") must together own more than 50% of the votes and value of the purchaser corporation, and all other shareholders must deal at arm's length with qualified individuals and the subject corporation, and must not be affiliated with the subject corporation.
- Because of the above restriction, the vendor may not receive any share consideration from the purchaser corporation (or any related corporation)[90], and any debt consideration must have reasonable repayment terms.

The submission suggests that the exception be claimed by way of an election filed with the corporate tax return for the year of the transaction[91], so that the CRA would have notice and could audit to ensure the requirements are satisfied. It's not entirely clear what reporting, if any, would be required in connection with a direct sale to a qualified individual, nor whether the particular hallmark conditions for the exception would need to be met starting at that time, or whether those conditions (and, therefore, possibly the election also) would only need to be met at the time of a subsequent disposition by the qualified individual to a purchaser corporation[92] (i.e. at that later time when section 84.1 would otherwise be relevant).

The submission also suggests that it would be appropriate to add a specific anti-avoidance rule that would deny the exception if the vendor reacquires direct or indirect control of the subject corporation within a certain time following the disposition[93]. It's not clear whether the contemplated rule would also deny the relief if the vendor later acquires shares of the purchaser corporation.

The CALU approach would avoid much, if not all, of the potential uncertainty and complexity inherent in the Quebec approach. This would be achieved, however, with some loss of flexibility and a different kind of restriction on the types of family business transfers that would be eligible.

The whole concept of requiring "active engagement" in a business of the corporation is avoided, but the clear focus on a "retirement" scenario as the base-case for relief is nevertheless maintained. Given that the suggested approach would not require the vendor to cease being active in the business (as an employee, for example), though, the proposed age threshold seems unduly restrictive[94]. Similarly, not including siblings as qualified individuals[95] would limit many bona fide transfers, including where "retirement" was an objective of one older brother or sister but not another (possibly younger) one. The exception would also not seem to be applicable on death, because the individual's estate (being a trust) would not be a qualified individual that could be entitled to the relief from the soft-basis rule (although it's possible that a rule could allow a qualified individual receiving shares from the estate to benefit)[96].

It is not clear why the vendor should not be allowed to continue to hold fixed-value preferred shares, at least, in either the subject corporation or the purchaser corporation following the disposition. These would typically be an economic substitute for the debt consideration that would be allowable, but obviously would permit the vendor to potentially defer recognition of some portion of the vendor's accrued gain inherent in the subject corporation shares. In the context of a transfer of a business interest to a family member, provided that the future growth entitlements have been given up, it would allow considerably more flexibility for managing the vendor's overall tax liability if preferred share debt substitutes could be retained (just as they could be in the context of a business transfer to a third party) following the disposition. The proposal allows a three-year period during which shares of the subject corporation could be retained (whether preferred or common), provided that control is given up immediately, but a longer retention period for preferred shares would not seem unreasonable.

Finally, the requirement that the shares (other than for farm or fishing corporations) be QSBC shares, means that access to the benefit of the V-day exemption is linked to this requirement. It seems inappropriate to deny V-day relief merely because the business might have become successful and expanded outside Canada, for example. The same concern would apply to "crystallized" LGCD amounts of the vendor, where the company similarly no longer qualifies as a QSBC.

Overall, CALU's suggested approach represents a more workable and flexible solution to the family business transfer concerns, as compared to the U.S. or Quebec approaches, but as noted above would continue to provide relief to only a subset of bona fide non-arm's length situations.

4.6 Surplus Computation

Another option could be the use of a surplus computation. Rather than attempting to select the hallmarks sufficiently similar to an arm's length sale, a surplus computation could attempt to identify and calculate the surplus which "should" be taxed as a dividend. Then upon the transfer of the subject shares which would otherwise trigger section 84.1, the computed amount would be deemed to be a dividend, notwithstanding the legal form of the consideration. This has the effect of ordering the distribution, *i.e.,* the amount which "should" be taxed as a dividend is considered distributed first. The tax consequence could be deferred, in theory, until the time at which any funds are received by the taxpayer from the purchaser corporation. Any deferral consequence would necessarily have to contemplate tracing and reorganization rules.

Because of the complexities involved, this could be an elective option (rather than mandatory) as it may be suitable only for certain taxpayers.

The interaction with any LCGD claimed or V-Day increment would have to be considered. In a share transfer otherwise subject to section 84.1, perhaps the price of access to such tax-free exemptions could be the immediate taxation of the appropriate amount of surplus as a dividend.

The crucial question is the amount of surplus which "should" be taxed as a dividend. A new surplus computation inherently reeks of complexity for any existing corporation with multiple shareholders and classes of shares; fiscal history involving reorganizations and change of shareholders and/or subsidiary corporation ownership. These raise questions of consolidation of balances and allocating the "right" amount of surplus to the "right" shareholder. Also, choosing the starting point for the calculation could be arbitrary and compliance may be difficult as a practical matter because of deficient historical records.

To avoid the complexity of a "new" surplus computation, consideration could be given the use of an existing balance such as safe income or GRIP. Both are a measure of undistributed income, calculated on a cumulative basis and reduced by dividends paid. However, both may have shortcomings.

- The computation of safe income is based, to a large extent, on administrative practice and this may raise concerns regarding certainty.
- GRIP is a statutory formula, but there are the following concerns.
    - GRIP excludes income which was taxed at the lower small business rate[97] and it is not clear that this is an appropriate exclusion in this context.
    - The transitional rule to create an opening balance of GRIP when the eligible dividend rules came into effect only took into account the five year history back to the 2000 taxation year.[98] Therefore the opening balance necessarily did not include all of the corporation's full rate taxable income.
    - Not all private corporations presently have a computed GRIP balance.[99]

In light of the above, rather than using the existing GRIP (if computed), consider applying the tax balance sheet approach in subsection 89(4) with some modification. This subsection otherwise applies to compute the addition to GRIP when a corporation becomes a CCPC and therefore provides an opening balance for GRIP. The approach contrasts to the historic taxable income tracking that might otherwise be considered a "pure" approach, similar to the manner in which safe income is computed and the transitional rule when the GRIP and the eligible dividend system came into effect (limited to a five year lookback as commented above). The tax balance sheet approach takes into account the cost amount of property and cash on hand, reduced by debts and paid-up capital of shares. Subsection 89(4) provides for a subtraction in the calculation of the corporation's LRIP which should not relevant in the context of the surplus computation under consideration. Adjustment to the subsection 89(4) calculation may be needed in respect of investment income. Generally, the refundable tax system creates an incentive to pay out a dividend triggering a dividend refund. However to the extent that there is NERDTOH or ERDTOH, there should be a deduction on account of such tax balances in determining the surplus amount.

Although it may be possible to compute a figure representing undistributed income using such a modified tax balance sheet approach, this does not complete the analysis. There remains the issue of allocating the "right" amount of surplus to the "right" shareholder. Therefore if shareholders and their share ownership have changed, a calculation may be required for the particular holding period among other issues. This seems to reintroduce complexity and for that reason, this "new" surplus computation approach does not seem feasible.

4.7 "Small Business Corporation" and Non-affiliated

Having considered the issues with a hallmarks approach and a "new" surplus computation approach as discussed above, we suggest the following approach based on "small business corporation"[100] ("SBC") status and transfers to non-affiliated persons. Because of the reference to existing statutory concepts, this approach provides relative simplicity and certainty and while relief is limited, the relief could be expanded with suitable qualifying share ownership parameters.

We suggest that section 84.1 should remain as is applicable to non-arm's length transfers (as defined therein) but with an exception for certain transfers of subject shares which are shares of an SBC. Because most transfers within a family group are transfers between related persons, such transfers are deemed non-arm's length and therefore necessarily within the relationship parameters of section 84.1. An exception could be created for transfers to related persons who are not affiliated.

One reason we suggest the use of an affiliated person test is because the concept is used to determine whether the recognition of certain losses should be "suspended" because the transferor continues to have a certain "economic connection" to the loss property. This tax policy recognizes that transfers between non-affiliated persons (even if the persons are related) are sufficiently *bona fide* that suspending those losses is not appropriate. If the policy is to allow the recognition of losses on transfers between these persons, it seems equally appropriate for section 84.1 not to apply on the transfer of an SBC to a non-affiliated person. We note also that prior to the introduction of the loss suspension rules in 1995, similar "stop-loss" rules applied on transfers between related persons. Consequently, prior to 1995 there was a more consistent policy between the loss denial rules and section 84.1. Introducing an exception to section 84.1 for dispositions of shares of an SBC where the transfer is between persons who are not affiliated with each other would reestablish that consistent policy.

(a) "Small Business Corporation" as the subject corporation

As a starting point, we focus on the surplus stripping concern and consider whether there may be situations where that concern is sufficiently reduced so that relief should be available.

If the subject corporation is an SBC at the time of disposition, then all or substantially all of the fair market value of the corporation's assets must be used in an active business carried on primarily in Canada[101] by it or a related corporation. The SBC definition can also be satisfied by a corporation all or substantially all of the fair market value of the assets of which are shares or indebtedness of connected (within the meaning of subsection 186(4)) small business corporations. Because of the "all or substantially all"[102] requirement, it seems that there should not be significant "non-business" cash on hand or passive investment (although the amount or value of same is relative to the overall fair market value). Our suggestion is that SBC status in and of itself may support the position that the purpose of the share transfer is not to surplus strip.

Limited cash on hand which is not necessary for the business at the time of disposition may mean that it is not possible to "backward strip" (*i.e.,* retained earnings). It is acknowledged however that this does not prevent a "forward strip" (*i.e.,* future earnings).

We acknowledge that SBC status in and of itself should not permit an exemption from section 84.1. However, we submit that SBC status may be regarded as a character defining trait given the definitional limitation of "non-business" assets. Thus, in the case of an Opco which is an SBC, perhaps the transfer of shares is indeed a business transition and similarly, in the case of a Holdco which has a sufficient interest in the corporation carrying on the active business to so qualify. While a holding corporation which owns as little as a 10.1% interest (votes and value) in the corporation carrying on the active business may itself qualify an SBC, the owner of such holding corporation is either a sufficiently minority participant that he/she alone cannot engineer a surplus strip of the operating business or an active but minority owner not to be treated differently for this purpose than a larger owner.

(b) Transfer of shares of SBC to non-affiliated person – ownership change parameters

We suggest an exemption from section 84.1 for share transfers between related persons who are not affiliated. Spouses and common-law partners are affiliated. A parent and child are not affiliated. Siblings are not affiliated. We suggest the following ownership change parameters for the exception.

(i) The subject corporation is an SBC immediately before the transfer of shares. For purposes of this condition, consider whether the reference to "in Canada" in paragraph (a) of the SBC definition in subsection 248(1) may be ignored.

(ii) The taxpayer is not affiliated with the purchaser corporation immediately before the disposition and does not become affiliated with the purchaser corporation (or another corporation that directly owns, or has an indirect interest in (see description below), any common shares of the subject corporation and in which the purchaser corporation holds common shares) as part of a series of transactions or events that includes the disposition.

The intention is that the taxpayer (together with affiliated persons) should not control the purchaser corporation and thereby indirectly continue to control the common share participation (if any) in the subject corporation that was transferred to the purchaser corporation. Accordingly, it is also necessary to ensure that this requirement is not avoided by having the purchaser corporation transfer common shares of the subject corporation into a holding corporation which the taxpayer controls (through voting, non-participating shares, perhaps).

(iii) The taxpayer is not affiliated with the subject corporation (or any other small business corporation an investment in which by the subject corporation, directly or indirectly, is required for the subject corporation's qualification as a small business corporation) immediately after the disposition and does not become affiliated following the disposition as part of a series of transactions or events that includes the disposition.

(iv) For purposes of 4.7(b)(ii) and (iii) above and 4.7(b)(v) below, section 251.1 is read without reference to the definition of "controlled" in subsection 251.1(3). In other words, "controlled" for this purpose shall mean *de jure* control and not "controlled, directly or indirectly, in any manner whatever".

A concern in this respect is that the debt (promissory note) consideration received by the taxpayer from the purchaser corporation could be sufficiently significant that the taxpayer might be considered to have a degree of economic control. In addition, it is possible that the taxpayer may continue to be involved operationally in the business. Both of these may be expected in a family business transition yet still result in the particular corporation being "controlled, directly or indirectly, in any manner whatever", especially in light of subsection 256(5.11). Accordingly, limiting the definition to *de jure* control provides a clearer test as to whether this proposed exception to section 84.1 would be applicable.[103]

(v) Neither the taxpayer nor any person affiliated with the taxpayer shall, immediately following the disposition directly own or have an indirect interest in (see description below), nor acquire (directly or as an indirect interest) following the disposition as part of a series of transactions or events which includes the disposition, any common or other participating shares of the subject corporation (or any other small business corporation an investment in which by the subject corporation, directly or indirectly, is required for the subject corporation's qualification as a small business corporation) or the purchaser corporation.

It may be possible to relax the above and permit the taxpayer to continue to have some percentage of common or other participating share ownership. The concern is the transaction does not constitute a "*bona fide*" transfer of the subject corporation to the related but non-affiliated person. For example, the taxpayer could relinquish *de jure* control of the subject corporation to the purchaser corporation (or the non-affiliated but related family members who control the purchaser corporation), and transfer preferred shares and some but not all common or participating shares to the purchaser corporation. The preferred shares being a debt substitute may be retracted with purchase price flowing to the taxpayer. Yet the taxpayer's economic interest in the subject corporation may not have sufficiently changed given continued common share ownership. The threshold at which the taxpayer's interest sufficiently changes to address the above concern is not clear but allowing no retained common or participating share ownership should clearly address the concern. It is recognized however that there may be circumstances where some limited degree of participating ownership may be desirable.

(vi) Indirect interests shall be determined by applying on a recursive basis, the rules in paragraphs 256(1.2)(d), (e), (f) and (g) as if the references therein to “shares” were read as references to “common or other participating shares” of the particular corporation or corporations.

(c) Transfer of SBC shares to non-affiliated person – “soft” basis changes

For purposes of this proposed exception, the “soft” basis rule should be similarly adjusted.

(i) If a disposition of shares fits within the exception outlined above, then basis hardens. For example, suppose a taxpayer (the “First Taxpayer”) transfers subject shares to a purchaser corporation, claims the LCGD and the transfer fits within the exception outlined above. If the subject shares become vested in another person for whom section 84.1 is being tested, if relevant, the LCGD claimed by the First Taxpayer should not be “soft” basis to such other person.

(ii) If an individual acquired shares from a non-arm’s length taxpayer where current subparagraph 84.1(2)(a.1) would otherwise treat the LCGD or V-Day increment claimed by that taxpayer or a person non-arm’s length with such taxpayer (the “Previous Taxpayer”) as “soft” basis, and at the particular time, the individual is transferring such shares to a purchaser corporation, such amounts shall not be “soft” basis provided that:

(A) The individual was not affiliated with the Previous Taxpayer at the time of the share acquisition; and

(B) The disposition to the purchaser corporation would satisfy the exception outlined in 4.7(b) above at the particular time, if the Previous Taxpayer (rather than the individual taxpayer) were required to meet the conditions in 4.7(b)(ii), (iii) and (v) above (that is, provided that the Previous Taxpayer is not affiliated with the purchaser corporation or the subject corporation and neither the Previous Taxpayer nor an affiliated person owns, directly or indirectly, any “prohibited” common shares).

Note that, for greater certainty, the proposed relief from the application of section 84.1 described in 4.7(b) above shall not be available in respect of a disposition where the exception from the “soft basis” rules described in 4.7(c) above would not be met because of the requirements in 4.7(c)(ii)(B). For example, if a Parent disposes of shares to a Child and claims the LCGD in respect of a gain on the disposition, the Child should not then be entitled to relief from section 84.1 on a later sale of those shares back to a purchaser corporation owned by the Parent (even though that subsequent disposition might have otherwise, on its own, met the proposed conditions for the relief).

5. CONCLUDING REMARKS

The question put forward in the 2017 Consultation Paper was how section 84.1 might be amended to facilitate "genuine" intergenerational transfers while addressing the government's surplus stripping concerns.

The analysis of a "genuine" transfer leads to comparison with an arm's length transfer. For this reason, a hallmarks approach has conceptual appeal. However, many hallmarks can be subject to interpretative issues and therefore lead to uncertainty. Purely objective criteria will inevitably be either under- or over-inclusive. Too-strict conditions will deny relief to many otherwise "deserving" family situations, while looser tests threaten the prospect of "abuse". Ultimately, any choice of particular hallmarks risks being arbitrary, resulting in winners and losers without conceptually clear distinctions.

Although no solution will be perfect, we believe that the suggested "SBC/Non-Affiliated" approach represents a reasonably balanced response to addressing these potential shortcomings. While this approach could be considered a variation of a hallmarks approach, its use of existing statutory concepts should allow greater certainty in application.

Framing the question in terms of purely "intergenerational" transfers has tended to result in a focus on retirement-type scenarios, and in our view, necessarily leads to suggested solutions targeted to that fact pattern alone. For this latter reason, we have considered the broader question of "interfamily" transfers. The relief which would be provided by the "SBC/Non-Affiliated" approach is not limited to the retirement-type scenario and could be available in a broader range of "genuine" family business transitions, including transfers between siblings and those resulting from the death of an owner, while still limiting the ability of taxpayers to obtain clearly inappropriate results. Refinements are undoubtedly necessary, but in the absence of more fundamental tax system reform, we believe that a workable legislative response along the lines suggested can be implemented to reduce the existing tax impediments to the interfamily transfer of private businesses.

APPENDIX A: EXCERPTS FROM QUEBEC TAXATION ACT

517.5.5. Where eligible shares of an individual, other than a trust, are disposed of in connection with an eligible business transfer of the individual and, but for this section, a dividend equal to the excess amount that corresponds to the amount by which the aggregate determined under section 517.3 exceeds the aggregate determined under section 517.3.1 would, under section 517.2, be deemed to have been paid by the purchaser corporation to the individual, and received by the individual from the purchaser corporation, at the time of the disposition of those shares, the following rules apply:

(a) the lesser of the amount of that excess amount and the amount determined in respect of the disposition of those shares under paragraph b of subsection 1 of section 84.1 of the Income Tax Act (R.S.C. 1985, c. 1 (5th Suppl.)) (in this section referred to as the "deemed dividend amount") is deemed to be a capital gain from the disposition of those shares, to the extent of the amount the individual designates to that effect in the individual's fiscal return filed under this Part (in this section referred to as the "designated capital gain") for the year of disposition, without, however, exceeding the amount (in this section referred to as the "particular amount") determined in accordance with the second paragraph, and, despite any other provision of this Act,

i. for the purposes of section 234, where a reserve is claimed in accordance with subparagraph b of the first paragraph of that section in respect of the portion of the proceeds of disposition of the shares that is payable after the end of the year of disposition, the gain from the disposition of those shares is deemed to be equal to the amount by which the designated capital gain exceeds the amount of the reserve (which excess amount is in this subparagraph and subparagraphs ii and iii referred to as the "reduced capital gain") and, for the purpose of determining the reserve that the individual may claim in respect of the disposition of the shares, subparagraph b of the first paragraph of section 234 is to be read without reference to its subparagraph iii,

ii. for the purpose of determining the tax payable under this Part by the individual for the year of disposition,

(1) section 28 is to be read, in respect of the designated capital gain or reduced capital gain, as the case may be, without reference to subparagraph ii of its paragraph b and, in respect of the amount the individual may subtract in accordance with its paragraph c, as if the designated capital gain or reduced capital gain were not taken into account for the purposes of subparagraph i of its paragraph b,

(2) an amount is deductible by the individual under Book IV, except Title VI.5, only to the extent that the individual's income, determined in accordance with subparagraph 1, exceeds one-half of the amount of the designated capital gain or reduced capital gain, as the case may be,

(3) an amount is deductible by the individual under Title VI.5 of Book IV, in respect of a capital gain other than the designated capital gain or reduced capital gain, as the case may be, only to the extent that the individual's taxable income, determined otherwise and taking subparagraphs 1 and 2 into account, exceeds one-half of the amount of the designated capital gain or reduced capital gain, and

(4) an amount is deductible by the individual under section 729 only to the extent that the excess amount referred to in paragraph b of section 28 that would be determined for the year, in respect of

the individual, if the amount of the designated capital gain or reduced capital gain, as the case may be, were not taken into account, and

iii. the amount determined under paragraph b of section 28, to which paragraph b of section 728.0.1 refers for the purpose of determining the individual's non-capital loss or farm loss for the year of disposition, and the amount determined under subparagraph i of paragraph b of section 28, to which paragraph a of section 730 refers for the purpose of determining the individual's net capital loss for the year of disposition, are computed without taking the amount of the designated capital gain or reduced capital gain, as the case may be, into account; and

(b) the amount of the designated capital gain in respect of the disposition of those shares is deemed not to be a dividend paid by the purchaser corporation and received by the individual at the time of the disposition of those shares.

The particular amount to which the first paragraph refers is equal to twice the least of the amounts that would be determined in respect of the individual for the year under paragraphs a to d of section 726.7 or 726.7.1, as the case may be, if the deemed dividend amount were a capital gain realized by the individual in the year from the disposition of shares of the capital stock of a family farm or fishing corporation or of eligible small business corporation shares, as the case may be, and if subparagraph 1 of subparagraph ii of subparagraph a of the first paragraph were not taken into account.

2017, c. 1, s. 137; 2017, c. 29, s. 76.

517.5.6. A series of transactions that includes the disposition by an individual of eligible primary and manufacturing sectors shares of a corporation (in this section referred to as the "particular corporation") may be considered to be an eligible business transfer of the individual only if the individual or the individual's spouse was, while the individual owned those shares and during the 24-month period that immediately preceded the disposition of the shares, actively engaged in a business carried on by the particular corporation or by a corporation in which the particular corporation had a substantial interest.

For the purposes of the first paragraph, the following rules apply:

(a) where the individual or the individual's spouse, as the case may be, is, immediately before the disposition of the shares, unable to actively engage in a business carried on by the particular corporation or by a corporation in which the particular corporation had a substantial interest due to an illness or a disability, the first paragraph is to be read as if "the 24-month period that immediately preceded the disposition of the shares" were replaced by "the 24-month period that preceded the time at which the individual's inability, or that of the individual's spouse, began";

(b) the individual is deemed, during the 24-month period that immediately precedes the disposition of the shares, to own the shares and to have been actively engaged in a business carried on by the particular corporation or by a corporation in which the particular corporation had a substantial interest if

i. the individual's spouse died in the 24-month period that precedes the disposition of the shares, and

ii. the individual or the individual's spouse was actively engaged in a business carried on by the particular corporation or by a corporation in which the particular corporation had a substantial interest during the 24-month period that precedes the date of death; and

(c) where an individual was actively engaged in a business during a particular period and all or substantially all of the assets used in the course of carrying on that business is disposed of to a corporation as consideration for shares of the capital stock of the corporation, the individual is deemed to have actively engaged in a business carried on by the corporation for the particular period.

2017, c. 1, s. 137; 2017, c. 29, s. 77.

517.5.7. A series of transactions that includes the disposition by an individual of eligible shares of a corporation (in this section referred to as the "particular corporation") may not be considered to be an eligible business transfer of the individual where, after the disposition of the shares, the individual or the individual's spouse is actively engaged in a qualified business carried on by the purchaser corporation, by the particular corporation or by a corporation in which the particular corporation has a substantial interest, unless

(a) the active engagement of the individual or the individual's spouse in that business for a particular period (in the second paragraph referred to as the "transition period") aims to encourage the transfer of the knowledge possessed by the individual or the individual's spouse in relation to that business for the benefit of other persons actively engaged in that business;

(b) substantially all the income from the business in which the individual or the individual's spouse is actively engaged is not derived from the sale, leasing, rental or development, as the case may be, of properties, or the rendering of services, similar to those of a business that, before the disposition of the shares, was carried on by the purchaser corporation, by the particular corporation or by a corporation in which the purchaser corporation or the particular corporation held a direct or indirect interest; or

(c) the active engagement of the individual or the individual's spouse in that business stems from the sole fact that the person referred to in section 517.5.11 is unable to actively engage in that business due to an illness, a disability or the person's death if the illness, disability or death begins or occurs after the disposition of the shares of the particular corporation.

For the purposes of subparagraph a of the first paragraph, for any calendar year included in whole or in part in the transition period, the remuneration received by an individual as consideration for services rendered in the calendar year or part of calendar year because the individual is actively engaged in a business carried on by the purchaser corporation, by the particular corporation or by a corporation in which the particular corporation has a substantial interest must not exceed the amount obtained by multiplying the Maximum Pensionable Earnings determined for the year under section 40 of the Act respecting the Québec Pension Plan (chapter R-9) by the proportion that the number of days in the calendar year that are included in whole or in part in the transition period is of 365.

2017, c. 1, s. 137; 2017, c. 29, s. 78.

517.5.8. A series of transactions that includes the disposition by an individual of eligible shares of a corporation (in this section referred to as the "particular corporation") may not be considered to be an eligible business transfer of the individual where, in the period that begins 30 days after the disposition of the shares and ends at the end of that series of transactions, the individual or the individual's spouse controls the particular corporation or a corporation in which the particular corporation had, immediately before the disposition of those shares, a substantial interest or is a member of a group of persons that controls such a corporation, unless the corporation is

(a) a corporation carrying on a business substantially all the income of which is not derived from the sale, leasing, rental or development, as the case may be, of properties, or the rendering of services, similar to those of a business that, before the disposition of the shares, was carried on by the purchaser corporation, by the particular corporation or by a corporation in which the purchaser corporation or the particular corporation held a direct or indirect interest; or

(b) a corporation that does not carry on a qualified business.

2017, c. 1, s. 137; 2017, c. 29, s. 79.

517.5.9. A series of transactions that includes the disposition by an individual of eligible shares of a corporation (in this section referred to as the "particular corporation") may not be considered to be an eligible business transfer of the individual where, in the period that begins 30 days after the disposition of the shares and ends at the end of that series of transactions, the individual or the individual's spouse holds, directly or indirectly, common shares of the capital stock of the particular corporation or of a corporation in which the particular corporation had, immediately before the disposition of those shares, a substantial interest, unless they are common shares of the capital stock of such a corporation that is

(a) a corporation carrying on a business substantially all the income of which is not derived from the sale, leasing, rental or development, as the case may be, of properties, or the rendering of services, similar to those of a business that, before the disposition of the shares, was carried on by the purchaser corporation, by the particular corporation or by a corporation in which the purchaser corporation or the particular corporation held a direct or indirect interest; or

(b) a corporation that does not carry on a qualified business.

2017, c. 1, s. 137; 2017, c. 29, s. 80.

517.5.10. A series of transactions that includes the disposition by an individual of eligible shares of a corporation (in this section referred to as the "particular corporation") may be considered to be an eligible business transfer of the individual only if

(a) throughout the period that begins 30 days after the disposition of the shares and ends at the end of that series of transactions, the aggregate of all amounts each of which is the amount of the residual financial interest of a person who is the individual, any other individual in respect of whom, but for this section, section 517.5.5 would apply in relation to the disposition of a share of the particular corporation in connection with that series of transactions, or their respective spouses, does not exceed

i. where the particular corporation is referred to in paragraph a of the definition of "eligible share" in the first paragraph of section 517.5.3, 80% of the aggregate of all amounts each of which is the fair market value, immediately before the beginning of the series of transactions, of a share of the capital stock of a corporation (in this section referred to as the "corporation concerned") that is the particular corporation, the purchaser corporation or a corporation in which the particular corporation has a substantial interest at that time, or

ii. where the particular corporation is referred to in paragraph b of the definition of "eligible share" in the first paragraph of section 517.5.3, 60% of the aggregate of all amounts each of which is the fair market value, immediately before the beginning of the series of transactions, of a share of the capital stock of a corporation concerned;

(b) the terms and conditions of reimbursement or redemption of the residual financial interests the amount of which is included in the first aggregate referred to in subparagraph a provide that no later than 10 years after the disposition of the shares, that aggregate will not exceed

i. where the particular corporation is referred to in paragraph a of the definition of "eligible share" in the first paragraph of section 517.5.3, 50% of the aggregate of all amounts each of which is the fair market value, immediately before the beginning of the series of transactions, of a share of the capital stock of a corporation concerned, or

ii. where the particular corporation is referred to in paragraph b of the definition of "eligible share" in the first paragraph of section 517.5.3, 30% of the aggregate of all amounts each of which is the fair market value, immediately before the beginning of the series of transactions, of a share of the capital stock of a corporation concerned;

(c) where the residual financial interest of a person described in subparagraph a includes a share of the capital stock of a corporation concerned,

i. the redemption of the share may not be required by the person before the expiry of the 10-year period referred to in subparagraph b unless the redemption aims to comply with the requirement of subparagraph i or ii of subparagraph b,

ii. the share entitles its holder to a cumulative dividend at a rate not exceeding a reasonable rate according to market conditions and the rate of that dividend is not based on a corporation's profitability,

iii. the share is redeemable at any time at the option of the corporation concerned, and

iv. the share is convertible only into one or more shares that satisfy the conditions of subparagraphs i to iii or into one or more debts that satisfy the conditions of subparagraphs i to iii of subparagraph d; and

(d) where the residual financial interest of a person described in subparagraph a includes a debt of a corporation concerned,

i. the reimbursement of the debt may not be required by the person before the expiry of the 10-year period referred to in subparagraph b unless the reimbursement aims to comply with the requirement of subparagraph i or ii of subparagraph b,

ii. the debt entitles its holder to a reasonable return according to market conditions and the return rate of the debt is not based on a corporation's profitability,

iii. the debt is reimbursable at any time, with accrued interest, at the option of the corporation concerned, and

iv. the debt is convertible only into one or more shares that satisfy the conditions of subparagraphs i to iii of subparagraph c or into one or more debts that satisfy the conditions of subparagraphs i to iii.

In this section, the amount of the residual financial interest of a person described in subparagraph a of the first paragraph, at any time, means an amount equal to the aggregate of all amounts each of which is the fair market value, at that time, of a financial interest that the person holds, directly or indirectly, in a corporation concerned and that is a share of the capital stock of the corporation concerned or a debt of the corporation concerned.

For the purposes of the second paragraph, the following rules apply:

(a) where a trust in which an individual or the individual's spouse has a beneficial interest holds, directly or indirectly, a financial interest in a corporation concerned, the individual is deemed to hold the financial interest;

(b) where an individual or the individual's spouse holds, directly or indirectly, a financial interest in an entity that is a trust, a partnership or a corporation, which entity holds, directly or indirectly, a financial interest in a corporation concerned, the individual is deemed to hold the financial interest in the corporation concerned; and

(c) where more than one individual would otherwise be required to include the same amount in computing their residual financial interest because of subparagraph a or b, only one of those individuals is required to take that amount into account in establishing the amount of that individual's residual financial interest in the corporation concerned.

For the purposes of subparagraphs a and b of the first paragraph, no account is to be taken of the residual financial interest of a person described in subparagraph a of the first paragraph in a corporation concerned or of the fair market value, immediately before the beginning of the series of transactions, of the shares of the capital stock of such a corporation, if that corporation is

(a) a corporation carrying on a business substantially all the income of which is not derived from the sale, leasing, rental or development, as the case may be, of properties, or the rendering of services, similar to those of a business that, before the disposition of the shares, was carried on by the particular corporation, by the purchaser corporation or by a corporation in which the purchaser corporation or the particular corporation held a direct or indirect interest; or

(b) a corporation that does not carry on a qualified business.

For the purpose of determining the end of the period described in subparagraph a of the first paragraph, the series of transactions to which that subparagraph applies is deemed not to include a transaction consisting in the redemption or reimbursement of the residual financial interest of an individual.

2017, c. 1, s. 137; 2017, c. 29, s. 81.

517.5.11. A series of transactions that includes the disposition by an individual of eligible shares of a corporation (in this section referred to as the "particular corporation") may be considered to be an eligible business transfer of the individual only if, in the period that begins immediately after the disposition of the shares and ends at the end of that series of transactions, at least one person (other than the individual) who holds, directly or indirectly, shares of the purchaser corporation, or the person's spouse, is actively engaged in a business carried on by the particular corporation or by a corporation in which the particular corporation had, immediately before the disposition of those shares, a substantial interest.

The first paragraph does not apply in respect of a period in which a person referred to in that paragraph who was to be actively engaged in a business is unable to be so actively engaged due to an illness, a disability or the person's death if the illness, disability or death begins or occurs after the disposition of the shares of the particular corporation.

2017, c. 1, s. 137; 2017, c. 29, s. 82.

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[2] RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as the "ITA"). Unless otherwise stated, all statutory references in this paper are to the ITA.

[3] 50 OR (3d) 728 (CA).

[4] Canada, Department of Finance, 2017 Budget, Building a Strong Middle Class, March 22, 2017, at p. 200.

[5] Canada, Department of Finance, Consultation Paper: Tax Planning Using Private Corporations, July 18, 2017, (the "2017 Consultation Paper") at p.58-59

[6] For example, see Joint Committee on Taxation of the Canadian Bar Association and Chartered Professional Accountants of Canada, "Re: July 18, 2017: Part D of Tax Planning Using Private Corporations—'Converting Income into Capital Gains' Proposals," submission to the Department of Finance, October 2, 2017, and STEP Canada, "Re: July 18, 2017 Proposals on Tax Planning Using Private Corporations", submission to the Department of Finance, October 2, 2017.

[7] See Department of Finance News Release, October 19 2017:

> "Minister Morneau announced today that the Government will not be moving forward with measures relating to the conversion of income into capital gains. During the consultation period, the Government heard from business owners, including many farmers and fishers that the measures could result in several unintended consequences, such as in respect of taxation upon death and potential challenges with intergenerational transfers of businesses. The Government will work with family businesses, including farming and fishing businesses, to make it more efficient, or less difficult, to hand down their businesses to the next generation.
>
> In the coming year, the Government will continue its outreach to farmers, fishers and other business owners to develop proposals to better accommodate intergenerational transfers of businesses while protecting the fairness of the tax system."

[8] See Canada, Department of Finance, 2019 Budget, Budget Plan, March 19, 2019, at 207, under the heading "Intergenerational Business Transfers".

[9] See sections 517.5.3 – 517.5.11 of the *Quebec Taxation Act*.

[10] See, *e.g.*, H. Heward Stikeman and Robert Couzin, "Surplus Stripping" (1995) 43:5 *Canadian Tax Journal* 1844-1860 ("Stikeman and Couzin"); Ron Durand and Lindsay Gwyer, "Surplus Stripping and Domestic Private Corporations," in *Report of Proceedings of the Sixty-Fourth Tax Conference*, 2012 Conference Report (Toronto: Canadian Tax Foundation, 2013), 13:1-20; Mark Meredith and Jacqueline Fehr, "Surplus Stripping: In the Eye of the Beholder," in 2013 British Columbia Tax Conference (Toronto: Canadian Tax Foundation, 2013), 14:1-29; "H. Michael Dolson and Jon D. Gilbert, What's Left, "Accessing Surplus: What Works, What Doesn't, What's Left," in 2014 Prairie Provinces Tax Conference (Toronto: Canadian Tax Foundation, 2014), 9:1-57 ("Dolson and Gilbert").

[11] Stikeman and Couzin, *supra*, at p. 1844.

[12] Dolson and Gilbert, *supra*, at p.4/5/6.

[13] With reference to former subsection 247(1), Sheldon Silver, "Surplus Stripping: A Practitioner's View" (1974) 22:5 *Canadian Tax Journal* 430-442, at p. 432/433.

[14] Canada, Report of the Royal Commission on Taxation, vol. 6 (Ottawa: Queen's Printer, 1966), Appendix D.

[15] *Copthorne Holdings Ltd. v. Canada*, 2011 SCC 63 at p. 118. See Monica Biringer, "Surplus Stripping After Copthorne: Non-Resident Corporations," in *Report of Proceedings of the Sixty-Fourth Tax Conferenc*e, 2012 Conference Report (Toronto: Canadian Tax Foundation, 2013), 14:1-25 at p.6

[16] *Supra*, note 14

> Furthermore, a shareholder in a public corporation can realize upon his share of the retained earnings by a tax-free sale of shares, thus effectively "stripping" his interest in the undistributed income without any distribution. In a closely held corporation, where the shareholders are more likely to be faced with an ultimate distribution of surplus, such indefinite postponement is not so readily available. In a real sense, surplus-stripping simply gave shareholders in closely held corporations the same advantage as was enjoyed by shareholders in those widely held corporations that retained a large part of their earnings. Both were able to avoid personal tax by the sale or liquidation of shares at prices unaffected by taxation.

[17] Pursuant to section 110.6 (the "LCGD").

[18] It is assumed that there is no V-Day increment. This is not an unreasonable assumption given that as of December 31, 2019, V-Day would be 48 years ago.

[19] If Opco is a multi-family company where the families are otherwise arm's length, then depending on the ownership structure and the particular shares transferred, Opco and Child Co may not be connected.

[20] Section 84.1 was added by SC 1974-75-76, c. 26, s. 47, applicable in respect of payments made after November 18, 1974. The heading to section 84.1 was "Deemed Dividend on Repayment of Debt".

[21] See the definition of "debt limit" in subsection 84.1(2) as it read prior to amendment by 1977-78, c.1, s. 39(1).

[22] Sheldon Silver and Stanley Taube, "Estate Planning: The Budget of November, 1974 and Bill C-49" (1975) 23:1 *Canadian Tax Journal* 63-68, at p.66.

[23] Technically, at the time the equivalent of the purchaser corporation in current section 84.1 incurred the debt as consideration for the purchase of shares.

[24] See discussion in Glen E. Cronkwright, Robert J. Dart, and Robert F. Lindsay, "Corporate Distributions and the 1977 Tax Changes," in *Report of Proceedings of the Twenty-Ninth Tax Conference*, 1977 Conference Report (Toronto: Canadian Tax Foundation, 1978), 279-363, at p.296/297 ("Cronkwright, Dart and Lindsay").

[25] See C. W. Primeau, "Surplus Stripping: The Departmental View" (1974) 22:5 *Canadian Tax Journal* 421-429 at p.422/423/424.

[26] S.C. 1977-78, c.1, s.39 applicable in respect of dispositions after March 31, 1977. The concepts of "debt limit", "paid-up capital limit" and "paid-up capital deficiency" were repealed.

[27] See Cronkwright, Dart and Lindsay, *supra*, note 24 at p. 283/284. See also *Interpretation Bulletin* IT-489 (cancelled), "Non-Arm's Length Sale of Shares to a Corporation", paragraph 7.

[28] J. R. Robertson, "Recent Developments in Federal Taxation," in *Report of Proceedings of the Thirtieth Tax Conference*, 1978 Conference Report (Toronto: Canadian Tax Foundation, 1980), 52-67, at p.59/60

> In view of the increased dividend tax credit for the 1978 and subsequent taxation years, the Department will no longer apply Subsection 247(1) where a resident shareholder arranges to receive the post-1971 retained earnings of a corporation as a capital gain, rather than as a taxable dividend. However, where matters are arranged so as to circumvent improperly the application of Section 84.1 or Section 212.1, the Department will consider the use of Subsection 247(1).

[29] SC 1986, c.6, s. 44(1) applicable in respect of dispositions made after May 22, 1985.

[30] *Descarries v. The Queen*, 2014 TCC 75, paragraph 53. It should be noted that *Descarries* was an Informal Procedure decision.

[31] *Pomerleau v. Canada*, 2018 FCA 129**,** at paragraph 77.

[32] *Ibid*, at para. 80-81:

> I also cannot accept the appellant's contention that section 84.1, when construed in accordance with its object, spirit and purpose, would reveal an intent to bypass its application when dealing with the intergenerational transfer of family businesses. As we have seen, this provision prevents persons who do not deal at arm's length from taking advantage of their close relationship in order to remove corporate surplus on a tax-free basis (*Copthorne*, paragraph 95). Nothing in the language or the object, spirit and purpose of this provision points to an intent to exclude from its scope such extractions when carried out by family members, no matter the context. That said, I believe it useful to point out that section 84.1 could, in certain cases, have a punitive effect in the context of an intergenerational transfer of a family business, for instance, where a corporation is sold by way of a share transfer at their FMV to a corporation controlled by the family member inheriting the business. In such a case, the transferor would pay tax on a deemed dividend whereas he or she would have realized a capital gain had the transferee been at arm's length.

[33] Especially to the extent that share or debt consideration is involved, with subsequent cash redemptions or repayments being funded, in part at least, by post-closing operating cash flow.

[34] That is, if the purchaser corporation deals at arm's length with the vendor, having regard to paragraph 84.1(2)(b) that can deem the parties not to be dealing at arm's length in certain cases.

[35] Where funds or property of the subject corporation can be considered to have been "distributed or appropriated in any manner whatever….on the winding-up, discontinuance or reorganization of its business". There is extensive case law and commentary on the application of this subsection. Note that this subsection remains a potentially powerful tool available to counteract certain forms of non-arm's length surplus stripping that would otherwise be outside the ambit of section 84.1, because of the existence of "hard ACB". Post-mortem "pipeline" planning must (and would continue to be required to carefully navigate) this rule, even to the extent that some relief from the application of section 84.1 can be provided.

[36] Such situations have often also attracted the application of subsection 84(2).

[37] See Ministère des Finances du Quebec, Budget 2016-2017 – Additional information, March 17, 2016, pages A38-A44

[38] *Supra*, note 6.

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[39] Conference for Advanced Life Underwriting, "Re: CALU Submission on the Department of Finance Consultation Paper Released July 18, 2017 Relating to Section 84.1 and Family Business Succession", September 29, 2017.

[40] The discussion in this section is not intended to be a detailed review of U.S. law and regulations, but merely a conceptual overview.

[41] A very rough analogue to the Canadian concept of "safe income", except that it is determined from the corporation's perspective rather than as an amount that tracks a particular shareholder's ownership period.

[42] Contrast this with Canada's tax rules for share redemptions, in subsection 84(3), that allow recovery of paid-up capital as a basis reduction but treat distributions in excess of paid-up capital as a deemed dividend regardless of whether the corporation has any undistributed realized tax surplus.

[43] See Internal Revenue Code ("IRC") section 302.

[44] Under current U.S. tax rules, both capital gains and dividends can be taxed at the same, preferential, tax rates for individuals that meet certain holding period tests, so the main benefit to an individual for exchange treatment versus deemed dividend treatment is the recognition of tax basis in the shares in the former case.

[45] IRC section 302(b)(3). Other exceptions can provide exchange treatment for certain redemptions, including on the complete liquidation of the corporation, or on a "partial liquidation" where a distinct part of a corporation's business is discontinued and related assets or proceeds from their disposition are distributed on the redemption.

[46] Although the attribution rules are extensive and complex, in general there is no attribution between siblings for purposes of these redemption rules.

[47] Note that under IRC section 304, where shares of one corporation are transferred to another corporation having sufficient commonality of ownership, the transfer can be treated as a share redemption. This could be viewed as a rough U.S. equivalent to the Canadian section 84.1 rules.

[48] Exchange treatment would be denied even to the extent that third parties control the corporation, either before or after the redemption and regardless as to whether the interest retained by a family member is otherwise "significant" from an economic perspective.

[49] The problem would be somewhat more severe in a U.S. tax context, because a taxable capital gain realized by the vendor individual does not allow the purchaser to access corporate funds without also triggering deemed dividend rules. In a Canadian context, it is only the "tax-free" portion of capital gains of the vendor that, in effect, prevents the purchaser from accessing corporate funds without deemed dividend treatment.

[50] But not certain other business entity attribution rules.

[51] See IRC section 302(c)(2).

[52] Regulations indicate that a person will be considered a creditor only if their rights with respect to the corporation are "not necessarily greater or broader in scope than necessary for the enforcement of his claim. Such claim must not in any sense be proprietary and must not be subordinate to the claims of general creditors."

[53] For example, an individual owing 100% of a corporation could transfer a portion of her shares to her spouse and have the corporation immediately redeem those shares. Alternatively, after the transfer to the spouse, the individual's shares could be redeemed, leaving the spouse with ongoing ownership of the company. Absent this condition, the spouse or the individual could otherwise qualify for the waiver of the attribution rules and achieve exchange treatment on what might in substance be a dividend distribution to the family unit.

[54] CQLR c.I-3, as amended.

[55] *Supra*, note 37.

[56] Accordingly, the limitations of the Quebec relief, as distinct from the specific "hallmark" conditions themselves described below, should not be taken as a model on which to base potential federal relieving measures. It is clear that Quebec's initiative was intended to be an "interim" measure and that federal action, with which Quebec could harmonize, could permit broader changes.

[57] See QTA section 517.5.5, reproduced in Appendix A for ease of reference. It is not clear why similar relief could not have been provided in respect of deemed dividends otherwise resulting from a V-day value exemption available to the vendor, or from V-day or LCGD "soft basis" inherent in the vendor's share ACB resulting from his or her own, or a non-arm's length person's, prior disposition (or, indeed, more generally in respect of any portion of the deemed dividend otherwise arising from the transfer). Rather, this seems to have been a policy decision, or perhaps simply recognition that requiring federal deemed dividend treatment as an "entry bar" to the Quebec relief would make it increasingly unlikely that taxpayers would seek to take "advantage" of such greater relief.

[58] QTA section 517.5.3

[59] Relief was originally limited to QSBC shares of a corporation in the "primary and manufacturing" sectors, in addition to shares of a family farm or fishing corporation, but the rules were subsequently broadened to cover all QSBC shares, pursuant to an announcement made on February 21, 2017.

[60] QTA section 517.5.3

[61] See sections 517.5.6 to 517.5.11 of the QTA, which set out the six conditions in detail. These are reproduced in Appendix A, for ease of reference.
[62] Within the meaning of subsection 191(2) of the ITA
[63] This illustrates but one of many situations where, because relief is limited to an individual's own LCGD claim on the disposition, more complicated sale transactions (and pre-sale share reorganizations) would be required to avoid having section 84.1 apply to the portion of the shares and related consideration that would not qualify for relief from deemed dividend treatment on a direct sale to the purchaser corporation.
[64] As defined in subsection 248(1).
[65] Which might include members that are both related (and, so, deemed non-arm's length) and unrelated (such as aunts, uncles and cousins)
[66] Note that the test for "connected" status, to avoid Part IV tax on intercorporate dividends and therefore also for determining whether section 84.1 would apply to a particular disposition, turns on owning shares with a FMV of more than 10% of the FMV of all the corporation's shares. As a result of a possible "minority discount" (in the absence of a robust shareholders' agreement that could otherwise ensure a pro rata value could be obtained), the actual ownership percentage required could be much higher than this.
[67] And subject to any agreement among the shareholders that would otherwise prevent the sale and active engagement in the business by the daughter in place of Mr. X.
[68] Note that if persons related to X Co also owned shares of Opco, the ownership interest required by X Co itself would be reduced accordingly.
[69] This could also be taken as further support for the inappropriateness of using "active engagement" as a criterion.
[70] A further condition, however, limits "remuneration" for services related to the business, for any calendar year part of which is during the transition period, to a pro rata portion of the QPP maximum pensionable earnings for that part of the calendar year.
[71] The concept is similar to that used for purposes of subsection 111(5) of the ITA.
[72] It is not clear why there is a "carve out" from this exception in respect of activity in a business carried on by a corporation in which the purchaser corporation held an interest, because the main limitation itself does not appear to restrict ongoing activity in any business carried on by any subsidiary of the purchaser corporation other than the subject corporation (and entities owned by it).
[73] Subparagraph (a)(ii) of the definition in subsection 146(1) of the ITA, which refers to a partner actively engaged in a business.
[74] CRA document no. 9210795, July 10, 1992
[75] Subsection 120.4(1) of the ITA.
[76] CRA document no. 2018-0783741E5, February 27, 2019.
[77] Paragraph 120.4(1.1)(a) of the ITA.
[78] Again, to us this suggests that the conditions regarding active engagement are simply unnecessary or inappropriate.
[79] If not, there wouldn't seem to be much point in the condition restricting all common share ownership, because common shares of the purchaser corporation could act as a proxy for subject corporation common shares. Other forms of "indirect" holding, including via partnerships and, possibly, certain trusts, are presumably contemplated as being caught, but the lack of specific "look-through" definitions for this purpose make the concept unclear. Contrast this with the detailed rules provided for the fifth condition, which do have certain specific look-through provisions.
[80] Having regard to the extended meaning of "series of transactions" in subsection 248(10).
[81] In this regard, it is interesting to compare the "series of transactions" approach with the U.S. "10-year undertaking" approach described above related to the U.S. share redemption family transfer relief. In exchange for a more definitive (but potentially longer) restriction period, the IRS would maintain the ability to enforce the restriction throughout the 10-year period. A middle-ground approach is used for purposes of subsection 69(11), where a fixed three-year period is used (rather than an open-ended series-based period) but backstopped with an unlimited reassessment period under subsection 69(12).
[82] There would be some inherent tension here, in that although the wording does not appear to *require* any particular minimum dividend rate, the prohibition on retraction rights would mean that the failure to employ a reasonable dividend rate might cause valuation issues, but choosing a rate that is too high will cause the loss of the entire desired tax benefit. Moreover, it is not clear whether the "market rate" refers to a rate than an arm's length person would negotiate for that specific instrument, or whether it is intended to reflect some kind of "generic" market rate. In any event, determining what an appropriate dividend rate would be is unlikely to be a simple task.
[83] See above comments – they will apply similarly to the determination of an appropriate interest rate.
[84] Although the 2016-2017 Budget documentation indicated that the rules would not result in an interest in the same corporation being double counted as a result of these look-through measures, the actual legislation does not appear to

achieve this. Instead, as described, the rules merely ensure that where the same amount in respect of a corporation concerned would be required to be included by more than one individual, only one such individual would include the amount. The multiple inclusion of amounts in respect of the same corporation for only one individual is NOT prevented.

85 Unless, of course, the ultimate requirement is simply for complete divestiture.

86 For example, to capitalize the purchaser corporation.

87 Assuming that a personal loan to an individual family member, whether secured or not, might not be considered to represent an "indirect" holding of property actually held directly or indirectly by that family member.

88 See the above discussion in note 81.

89 Although not specified in the submission, it is assumed that "affiliated" was intended to mean the concept defined in section 251.1.

90 Note that the submission suggests that the exception "would not be available on that portion of the proceeds that represent shares in the purchaser or any related corporation", but the fourth condition seems to in fact require that the vendor (being a person who would not deal at arm's length with a qualified individual) would simply not be allowed to hold any shares of the purchaser. Accordingly, it's not entirely clear which condition would take precedence.

91 Although not specified, presumably this would be the purchaser corporation, which would otherwise be the corporation deemed to have paid a dividend to the vendor pursuant to section 84.1. It's not entirely clear what reporting, if any, would be required in connection with a direct sale to a qualified individual, nor whether the particular

92 Clearly the QSBC or family farm/fishing corporation status of the shares would need to be met by the vendor at the time of the first disposition to the qualified individual, but it's not clear whether this share status would need to continue to be met at the time of the subsequent disposition by the qualified individual to the purchaser corporation, nor whether the status of the share at that second disposition time would be determined in respect of the qualified individual or the original vendor (for example, would a qualified individual who is not "related" to the vendor – a nephew/niece, for example, need to meet their own 24-month holding period test, or would they be deemed to be related to the vendor for this purpose ?).

93 CALU suggests that the rule be modeled on proposed anti-avoidance rules contained in the 2015 draft proposals related to exemptions from capital gains on donations of private corporation shares and real property interests. That rule used a 60-month timeframe following the disposition as a "testing" period.

94 In fact, the vendor would not be required to have been active in the first place, which makes the age-limit as a proxy for "retirement" somewhat questionable.

95 Especially given that a child of a sibling would qualify. Note that the proposal doesn't clearly indicate whether spouses of qualified individuals would themselves be treated as qualified individuals. Presumably that should be acceptable.

96 It would also seem reasonable to ignore an age restriction in the case of death.

97 See definition of "adjusted taxable income" in subsection 89(1).

98 See subsection 89(7).

99 Some private corporations may not be CCPCs. Some private corporations may have made an election pursuant to subsection 89(11).

100 As defined in subsection 248(1).

101 It is not clear that the requirement for the active business to be "carried on primarily in Canada" in the SBC definition is necessary for the relieving suggestion herein. However, if the taxpayer wishes to claim the LCGD on the transfer of shares (as opposed to a situation where there was a prior crystallization), it is clear all components of the SBC definition must be satisfied at the time of disposition in addition to the requirements of "qualified small business corporation share" in section 110.6.

102 Generally accepted by CRA to mean a 90% measurement, see *Interpretation Bulletin* IT-291R3 (Archived), "Transfer of property to a corporation under subsection 85(1)", January 12, 2004. Some cases have suggested a lower threshold albeit in other contexts, see *e.g., Douglas Wood v. MNR*, 92 DTC 1472 (TCC) – 70%; *Reluxicorp Inc. v. The Queen*, 2011 TCC 336 – 74.83%.

103 We note that there is a similar restriction in the "affiliated" definition as it applies in subsection 69(11.)