Tax Topics

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Wolters Kluwer

TAX PLANNING FOR THE NON-SPECIALIST ADVISOR — NEW SUCCESSION PLANNING STRATEGY FOR THE OWNER-MANAGER: PART II

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Part I of this two-part series of articles (the "Series") contained a non-technical discussion of surplus stripping and the impact of section 84.1 of the *Income Tax Act* (the "*Act*")[1] on owner-manager succession involving non-arm's length[2] corporate purchasers (i.e., the Section 84.1 Penalty). In addition, Part I provided a review of the surprising legislative effort to alleviate the Section 84.1 Penalty in limited circumstances, including a high-level review of the technical requirements needed to ensure that, in those limited circumstances, the Section 84.1 Penalty would not be applicable. Part II of the Series will provide a practical example to illustrate both the Section 84.1 Penalty and how amended section 84.1 will alleviate the Section 84.1 Penalty in certain limited situations. Part II will also describe ongoing concerns and issues with relying on amended section 84.1.

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Supporting Intergenerational Private Enterprise Succession — An Illustration of the Tax Impact of Eliminating the Section 84.1 Penalty

Owner-managers who are able to take advantage of amended section 84.1 to sell qualified small business corporation ("QSBC") shares or shares of family farm or fishing corporations (collectively, the "Qualifying Shares") to a non-arm's length purchaser corporation that meets certain conditions that will deem the purchaser corporation to act at arm's length with the vendor (collectively, the "Deemed Arm's Length Conditions", which are described in detail in Part I of the Series) may enjoy significant intergenerational tax savings.

As an example, Linda has successfully grown an incorporated bridal business, La Boutique Inc. ("LBI"), in Toronto, Ontario. She has always been the sole shareholder of LBI and she originally acquired her shares of the corporation by subscription for $10 so that their adjusted cost base ("ACB") and paid-up capital ("PUC") are also $10.

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[1] R.S.C. 1985, c. 1 (5th Supp.), as amended. Unless otherwise noted all statutory references are to the Act.

In this article all tax rates are assumed to be the top 2022 marginal Ontario tax rate for an individual taxpayer.

[2] Determined in accordance with subsection 251(1).

An arm's length international conglomerate ("IC") recently offered Linda just over $1,000,000 for all of the shares of LBI. As a result, Linda's professional advisors have told her that if she sold the shares of LBI she would realize a capital gain of, to keep the numbers simple, $1,000,000.

The professional advisors have also advised Linda that:

(1) the LBI shares are QSBC shares;

(2) she has never before claimed any of her lifetime capital gains exemption ("CGE"); and

(3) there are no impediments that would impact her ability to utilize her CGE.[3]

As a result, the professional advisors tell Linda that for tax purposes she could offset $913,360 of the capital gains with her CGE and would only pay tax on $86,640 of capital gains, resulting in a total tax liability to Linda of just over **$23,000**.

Linda's granddaughter, Beth, had always dreamed of one day buying Linda's shares of LBI and keeping her grandmother's business within the family.

Beth has diligently worked to create her own successful incorporated floral business, Fleurs Inc. ("Fleurs"), and she feels that LBI's business would complement her floral business.

Beth is more than happy to buy LBI from Linda on exactly the same terms as IC — for $1,000,000 cash.

Beth was advised to have Fleurs purchase Linda's shares of LBI so that the purchase price can be paid with active business income from Fleurs, which has been taxed in Fleurs at a lower rate than Beth would have to pay personally if she had to remove the cash from Fleurs.

Prior to the amendments to section 84.1, the acquisition would have been subject to the Section 84.1 Penalty.

As a result, it is assumed that section 84.1 would have given rise to a $1,000,000 deemed dividend being received by Linda, resulting in Linda paying tax of **$477,400**.

In the absence of the amendments to section 84.1, selling LBI to Fleurs would cost Linda over **$450,000** more than a sale to IC. As a result, Linda had indicated to Beth that she would have had no choice but to sell LBI to IC.

However, thanks to the amendments to section 84.1, the sale of the LBI shares to Fleurs will not be subject to amended section 84.1, provided that Linda is able to comply with certain administrative requirements set out in the legislation, described in detail in Part I of the Series (the "Administrative Requirements"). This is because the LBI shares, being QSBC shares, will be Qualifying Shares and a sale of the LBI shares to Fleurs, which is owned by Linda's granddaughter, will meet the Deemed Arm's Length Conditions. Consequently, the amendments to section 84.1 will, in these circumstances, have eliminated the Section 84.1 Penalty, levelling the playing field between arm's length and non-arm's length purchasers of LBI, making it possible for LBI to remain a family business.

Unfortunately, the relief from the Section 84.1 Penalty is really quite narrow. For example, had Beth been a non-arm's length person other than a child or grandchild of Linda,[4] the amendments to section 84.1 would not have been sufficient to avoid the Section 84.1 Penalty.

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[3] She has never claimed an "allowable business investment loss" (see paragraph 39(1)(*c*), sometimes referred to as an "ABIL") and she does not have a "cumulative net investment loss" balance (see subsection 110.6(1), sometimes referred to as a "CNIL balance"). Also, she earns sufficient income so that "alternative minimum tax" (see section 127.5 and related provisions, sometimes referred to as "AMT") will not be applicable.

[4] Other non-arm's length persons that are not protected from the Section 84.1 Penalty would include:

(1) All other persons who are "related" to the transferor (see paragraph 251(1)(*a*)). "Related persons" under the Act is a complex concept that includes persons with "blood relationships," including siblings, relations through marriage or common-law partnership, and adoption (subsection 251(6)), and certain corporations (subsection 251(2));

(2) Relations with certain trusts (paragraph 251(1)(*b*); and

(3) Factually non-arm's length persons (paragraph 251(1)(*c*)).

In addition, a transfer from an individual to related persons of a more senior generation would not be eligible for relief from the Section 84.1 Penalty.

Minister of Finance Has Issues With Bill C-208

As previously mentioned, Bill C-208's enactment proceeded without oversight or comments from the Minister of Finance ("MoF").

Consequently, the drafting of the amended provisions is far from precise,[5] and within weeks of its enactment the MoF confirmed its intention to seek to amend the legislation to address identified loopholes that it believes are contrary to the object, spirit, and purpose of the enacted changes.[6] The MoF provided a list of some of the issues that the amendments are intended to address in a news release on July 19, 2021 (see "Government of Canada clarifies taxation for intergenerational transfers of small business shares"), which include:

(1) The requirement to transfer legal and factual control of the corporation carrying on the business from the parent to their child or grandchild;

(2) The level of ownership in the corporation carrying on the business that the parent can maintain for a reasonable time after the transfer;

(3) The requirements and timeline for the parent to transition their involvement in the business to the next generation; and

(4) The level of involvement of the child or grandchild in the business after the transfer.

Although the MoF indicated that amendments were to be made by November 1, 2021, with effect from January 1, 2022, no announcement has been made to the present date.

As a result of the MoF warnings, a number of authors have warned taxpayers about relying on amended section 84.1, especially when the taxpayer's plans are not truly motivated by intergenerational Qualifying Share transfer considerations.[7]

Relying on Amendments to Section 84.1

Notwithstanding the caveats noted above, the enactment of Bill C-208 has changed section 84.1. In appropriate intergenerational transfer situations, amended section 84.1 now offers owner-managers a tax-efficient intergenerational succession planning strategy to transfer Qualifying Shares that satisfy the Deemed Arm's Length Conditions and meet the Administrative Requirements.

As mentioned previously, unfortunately, not all succession planning will involve Qualifying Share transfers that are able to satisfy the Deemed Arm's Length Conditions. Thankfully, there are other succession planning strategies available for owner-managers (e.g., the use of an estate freeze, insurance strategies, etc.), so it is important for owner-managers to consult with qualified tax and other multi-disciplinary professionals to help determine the most effective approach to meet their own personal and broader family current and long-term tax and non-tax objectives.

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[5] Some of the "warts" have been written about and discussed. For example, see Nichols and Horning Wolters Kluwer Canada *Tax Topics*, "When Parliamentarians Tinker," July 6, 2021, no. 2574: 1–3; and Jennifer Reid and Danielle Wallace, "Intergenerational Transfers of Businesses and Bill C-208: Where We Are Now" 2021 *Canadian Tax Focus* 11(4): 1–2.

[6] Chrystia Freeland, Deputy Prime Minister and Minister of Finance, addressed the requirement for the amendments by saying that "...The law is the law. Our concern is with technical elements of the bill that could unintentionally present opportunities for tax avoidance. The amendments we intend to bring will honour the law passed by Parliament, make sure everyone pays their fair share, and support the families and small businesses that keep our economy, and our communities, strong."

[7] For example, see Mezzetta, "Will CRA challenge small biz transfers that use Bill C-208?" Advisor's Edge, July 27, 2021. For a more technical discussion see Nichols and Horning Wolters Kluwer Canada *Tax Topics*, "*Deans Knight* Intersects Bill C-208: The Meaning of Control and Implications for Intergenerational Transfers," August 31, 2021, no. 2582: 1–2. Tax planners might wish to also review *The Queen v. Alta Energy*, 2021 DTC 5125 (SCC) and *Canada v. Loblaw Financial Holdings Inc.*, 2021 DTC 5131 (SCC), both of which appear to take a more measured approach to the ability of taxpayers to plan their affairs than in the *Deans Knight* (2021 DTC 5095 (FCA)) decision referenced in the Nichols and Horning article.

COVID-19 UPDATE

Federal

Support for Audiovisual Industry (February 11, 2022)

The federal government announced a second extension of the Short-Term Compensation Fund for Canadian audiovisual productions. Telefilm Canada will continue to provide as much as $150 million in compensation until 2023 to production companies whose filming has been interrupted or abandoned because of a COVID-19 diagnosis or outbreak. The Fund will end on March 31, 2023.

Provincial

British Columbia

Support for Business Events and Conferences Sector (February 10, 2022)

Business events and workforce support initiatives, such as hiring and retaining employees, in the tourism sector will receive more than $9.3 million over the next two years as part of the Tourism Recovery Initiatives Action Plan.

The new Business Events and Conferences Restart Fund will provide up to $5 million this fiscal year and up to $3 million next year to help restart business travel. Funding will be provided to city destination management organizations that were significantly involved in attracting and hosting business events, conferences, and exhibitions before the pandemic. Eligible organizations will be invited to submit proposals to access this funding.

Further, to help address serious challenges to recruit and retain workers in tourism and hospitality, BC is investing in human resources support for this sector. More than $1.3 million will fund dedicated human resources specialists in five tourism regions for two years. In partnership with the tourism industry's human resources association, go2HR, these individuals will provide expert advice to tourism operators in each region, including workforce strategy, recruitment, onboarding, compensation, training, health and safety, and interpreting employment legislation.

CURRENT ITEMS OF INTEREST

Subsidy Regulations Enacted

On February 16, 2022, Regulations Amending the Income Tax Regulations (SOR/2022-11) were published in the Canada Gazette. These new regulations implement the previously announced expansion of the Local Lockdown Program applicable to the 24th and 25th qualifying periods. However, this does not include the extension of these measures to the 26th qualifying period that was recently announced on February 9.

INTERNATIONAL NEWS

US IRS To Pause Some Tax Enforcement Proceedings

The US Internal Revenue Service ("IRS") has suspended the use of more than a dozen additional letters, including the mailing of automated collection notices, normally issued when a taxpayer owes additional tax and the IRS has no record of a taxpayer filing a tax return.

These suspended mailings include balance-due notices and unfiled tax return notices. The pause is due to the COVID-19 pandemic. The agency entered this filing season with several million original and amended returns filed by individuals and businesses not processed. The step is to help avoid confusion for taxpayers and tax professionals, the IRS said.

"IRS employees are committed to doing everything possible with our limited resources to help people during this period," said IRS Commissioner Chuck Rettig. "We are working hard, long hours pushing creative paths forward in an

effort to be part of the solution, rather than the problem. Our employees continue to expend every effort to balance a confluence of multiple, unprecedented demands — including successfully starting the filing season, working our inventory of unprocessed tax returns as well as looking for additional ways to minimize burden for taxpayers, tax professionals, and businesses."

"Our efforts are not limited to suspension of these additional letters and the possibility of similar actions going forward. We have redeployed and reallocated resources throughout the IRS and have implemented innovative strategies in an ongoing effort to provide a meaningful reduction in our inventories," Rettig said.

Specifically, for individuals, the IRS has suspended issuance of the following notices:

- CP80 — Unfiled Tax Return. This notice is generally sent when the IRS credited payments and/or other credits to a taxpayer's account for the tax period shown on the notice, but the IRS hasn't received a tax return for that tax period.
- CP59 and CP759 (in Spanish) — Unfiled Tax Return(s), 1st Notice.
- CP516 and CP616 (in Spanish) — Unfiled Tax Returns, 2nd Notice.
- CP518 and CP618 (in Spanish) — Final Notice — Return Delinquency.
- CP501 — Balance Due — 1st Notice.
- CP503 — Balance Due — 2nd Notice.
- CP504 — Final Balance Due Notice — 3rd Notice, Intent to Levy.
- 2802C — Withholding Compliance letter.

For businesses, the IRS has suspended the following notices:

- CP259 and CP959 (in Spanish) — Return Delinquency, sent when there is no record of a prior-year return being filed.
- CP518 and CP618 (in Spanish) — Final Notice — Return Delinquency.

Some taxpayers and tax professionals may still receive these notices during the next few weeks. The IRS said:

> Generally, there is no need to call or respond to the notice as the IRS continues to process prior year tax returns as quickly as possible. However, if a taxpayer or tax professional believes a notice is accurate, they should act to rectify the situation for the well-being of the taxpayer. [. . .] people with a balance due that interest and penalties can continue to accrue. In addition, IRS employees may in select circumstances issue notices to particular taxpayers to resolve specific compliance issues.

The agency said the IRS does not have the authority to stop all notices as many are legally required to be issued within a certain timeframe. The agency said:

> The IRS will continue to assess other changes and system modifications that the IRS may be able to implement to assist taxpayers on an array of issues. The IRS will continue to make information available to taxpayers throughout the filing season.

The IRS said the agency will decide in the future when to resume issuing these notices, based on the inventory of prior-year returns.

Bahrain To Soon Ratify the BEPS MLI

Bahrain's King has ratified Law (2) of 2022, endorsing ratification of the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (the "BEPS MLI").

Bahrain signed up to the BEPS MLI on November 27, 2020.

The MLI was developed through negotiations involving more than 100 countries and jurisdictions. The MLI enables countries to modify their existing tax treaties to include measures developed under the OECD/G20 BEPS project without having to individually renegotiate these treaties. The instrument will implement minimum standards to counter

treaty abuse, prevent the artificial avoidance of permanent establishment status, neutralize the effects of hybrid mismatch arrangements, and improve dispute resolution mechanisms.

Jurisdictions may choose, when ratifying the BEPS MLI, which of their treaties they wish to amend through the MLI. Bahrain has listed 44 double tax agreements signed with other countries as covered agreements for the purposes of the BEPS MLI.

The MLI will become effective from the first day of the fourth month after Bahrain deposits its instrument of ratification with the OECD — that is, it would become effective from June 1, 2022, if Bahrain ratifies the deal during February 2022.

RECENT CASES

Appeal allowed in a case relating to the tax payable by the estate of a deceased taxpayer; Minister ordered to reassess and allow deduction of amount paid to beneficiaries pursuant to s. 104(6)

This case concerns an assessment raised by the Minister against the estate of Georges Robillard ("the Estate") with respect to the 2013 taxation year. At the time of his death, Mr. Robillard was the sole shareholder of Gestion Georges Robillard Inc. ("Gesco"), a Canadian private corporation holding company that held Mr. Robillard's investments. Mr. Robillard bequeathed the shares equally to his three universal legatees (beneficiaries). By reason of his death, Mr. Robillard is deemed to have disposed of his shares at their fair market value ("FMV") resulting in a capital gain of $1,912,467. The Minister also considered that subsection 84(2) of the *Income Tax Act* (the "Act") applied in the circumstances, resulting in a deemed dividend of $1,567,016 for the Estate. To avoid this double taxation issue, the liquidators, based on the advice of their tax advisor, had put in a place a post-mortem pipeline tax planning strategy. These operations intended to use the adjusted cost base related to the deemed disposition of Gesco's shares to distribute Gesco's assets as capital. The appellant argued that subsection 84(2) was not applicable. Both parties also asked the Court if, considering subsection 84(2), the Estate may deduct in its 2013 tax return sums paid to the beneficiaries pursuant to subsection 104(6) of the Act. These represented an amount totalling $759,000.

The appeal was allowed. The Minister's position regarding subsection 84(2) relied principally on a Federal Court of Appeal ("FCA") decision, *The Queen v. MacDonald* (2013 DTC 5091). The Tax Court stated that this case has created a lot of uncertainty and some confusion. In the case at hand, the TCC found some merit in the appellant's position that the *MacDonald* decision should not apply in these specific circumstances. The Tax Court judge found some ambiguities in the *Macdonald* case that could, in his opinion, warrant the case to be reviewed. Nevertheless, in view of the *stare decisis* rule, the TCC is subject to the conclusions reached by the FCA in the *MacDonald* decision. Only the FCA may reexamine the *MacDonald* decision. Therefore, subsection 84(2) was ruled applicable. On the other hand, the TCC agreed with the appellant's position that pursuant to subsection 104(6) the Estate should be able to deduct the $759,000 amount paid to the universal legatees. Accordingly, the appeal was allowed and the Minister ordered to reassess in order to allow the Estate the $759,000 deduction.

¶50,799, *Robillard (Succession) v. The Queen*, 2022 DTC 1006

Application to extend the time to file a notice of objection dismissed

The applicant first came to Canada under a temporary work visa from 2011 to 2012. He worked for Tata Consultancy Services ("Tata"). Tata paid a housing allowance to the applicant during his residency in Canada. He filed his Canadian tax returns for 2011 and 2012. While he reported his Canadian income in Canada, he (like all other Tata work visa employees) did not claim the housing allowance. Tata did not issue a T4A to such employees. The Minister reassessed the applicant and other Tata employees, asserting that the housing allowance was taxable. Those assessments arose during the 2014–2015 period. Unlike other Tata employees, the applicant was no longer in Canada, having left in November 2012. Therefore, the notices of reassessment were sent to the applicant's last address in Canada on file with the CRA. From 2013 to 2019, the applicant lived in various locations around the world. He returned to Canada in 2019 and has lived here since. After his return, he discovered the uncontested 2015 reassessment and the resulting

outstanding tax debt and accrued interest in May 2020. He took action, objected, and received the Minister's response: any objection to the sent notices of reassessment was long overdue, nullifying any ability to appeal. The applicant applied for an extension of time to file a notice of objection.

The appeal was dismissed. The applicant's wages hover at subsistence and he's the sole wage earner for his family, including his aged and ill father in India. He cannot afford to pay the tax debt. Furthermore, the Minister reconsidered the taxable benefit concerning the housing allowance for other Tata employees who did object to the reassessed taxable housing benefit. Those successful resolutions occurred after specific taxpayers filed timely notices of objection. The evidence shows the applicant's last recorded address for service was the address in Canada to which the reassessments were sent. The applicant confirmed the address and that the reassessments were likely sent to him there. The *Income Tax Act* is clear on when and only when courts may grant an application to extend the time to file a notice of objection. Unless an application has been submitted before the expiration of the one-year period after the initial 90-day appeal period, the Court, like the Minister, is prohibited by Parliament from granting the application. Similarly, the sending by the Minister of the (re)assessment to the last known address on file is the critical event and date, not its receipt by the taxpayer. There is no legal or factual basis or combination thereof which affords the Court power to grant the application. The application was dismissed, even with the sympathetic circumstances, but the Court did suggest (it could not order) a voluntary reassessment by the Minister with the consent of the taxpayer or making a request for an interest waiver.

¶50,797, *Rajagopala v. The Queen*, 2022 DTC 1004

Severance payment is "retiring allowance", cannot add to RRSP contribution room

After losing his job, the appellant negotiated a severance payment of some $165,000, which he received in 2014 and included in his taxable income. In February 2015, he made a contribution of $24,270 to his RRSP. In 2018, the CRA assessed the appellant for $1,106.28 in Part X.1 tax on the ground that he had overcontributed to the RRSP.

The Tax Court allowed the appeal and instructed the CRA to reconsider and reassess. The severance payment was not employment income and was not taxable on that basis. In response to an FCA decision to that effect, Parliament defined such payments as "retiring allowances" and made them taxable under subsection 56(1) of the *Income Tax Act*. In addition, the appellant argued that the CRA had made errors in calculating the tax. The Court agreed that there were errors and that the CRA had overlooked critical information, and calculated the tax due as $682.33.

¶50,798, *Wyrstiuk v. The Queen*, 2022 DTC 1005

Tax Court upholds tax and late filing penalties

The appellant, a corporation owned by Mr. Chmielewska and his wife, engaged in cross-border produce delivery. Proceeding under subsection 152(7) of the *Income Tax Act*, the CRA made an "arbitrary assessment" that assessed the appellant for tax and late filing penalties for its 2012, 2013, and 2017 tax years. The appellant appealed.

The appeal was dismissed. Mr. Chmielewska testified that the truck and the laptop on which he kept his 2012 and 2013 tax records were involved in a crash in 2018, but the Court could find no record that he made any attempt to retrieve it or its cloud-based data. Evincing what the Court called a "rather casual approach to financial record-keeping", Mr. Chmielewska kept corporate receipts and invoices at his home in Toronto but brought only a one-page summary of revenue and operating expenses to the Court, claiming that the records were in cumbersome "big boxes." The Court assigned little weight to this summary, indeed drawing the inference that the full records either did not exist or would not benefit the appellant's case. The CRA's method of computing the appellant's taxes was reasonable under these circumstances. The late filing penalties were also reasonable in view of the appellant's complete failure to produce evidence that the returns in question were filed in time.

¶50,796, *Eva Enterprises v. The Queen*, 2022 DTC 1003

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