

TAX NOTES

May 27, 2021

Private Member's Bill C-208

Bill C-208 passed third reading of the House of Commons on May 12, 2021. Subject to the bill passing Senate review and receiving Royal Assent, the bill will amend paragraph 55(5)(e) and section 84.1 of the *Income Tax Act* (Canada). The stated purpose and summary of the bill is as follows:

This enactment amends the Income Tax Act in order to provide that, in the case of qualified small business corporation shares and shares of the capital stock of a family farm or fishing corporation, siblings are deemed not to be dealing at arm's length and to be related, and that, under certain conditions, the transfer of those shares by a taxpayer to the taxpayer's child or grandchild who is 18 years of age or older is to be excluded from the anti-avoidance rule of section 84.1.

Bill C-208 is a private member's bill sponsored by Larry Maguire, the MP for Brandon-Souris (CPC).

Paragraph 55(5)(e) Amendment

The first element of the bill is relatively straightforward. Current paragraph 55(5)(e) deems siblings to not be related for purposes of subsection 55(2). The bill amends paragraph 55(5)(e) to provide an exception to this deeming rule (such that siblings will be related for purposes of subsection 55(2)) where the dividend was received or paid by a corporation a share of which is a qualified small business corporation share ("**QSBC Share**") or a share of a family farm or fishing corporation ("**Farm or Fishing Shares**"), as those terms are defined in subsection 110.6(1).

This amendment will mean that the paragraph 55(3)(a) exception to the application of subsection 55(2) could be relied upon in completing a related party divisive reorganization involving siblings, provided that the shares of the reorganized corporation are QSBC Shares or Farm or Fishing Shares.

Section 84.1 Amendments

The second element of the bill appears relatively straightforward, but its intended operation may be frustrated by the bill's unusual drafting style.

Very generally, current subsection 84.1(1) applies where an individual or trust disposes of shares of a corporation ("**Subject Corporation**") to another corporation with which the taxpayer does not deal at arm's length ("**Purchaser Corporation**") and immediately after the disposition the Subject Corporation is connected with the Purchaser Corporation. There are two potential consequences if subsection 84.1(1) applies. First, the paid-up capital ("**PUC**") of the shares of the Purchaser Corporation issued as consideration for the shares of the Subject Corporation is limited to the PUC of the Subject Corporation's shares less any non-share consideration received by the taxpayer on the disposition. Second, the

taxpayer is deemed to have received a dividend equal to the amount by which the non-share consideration exceeds the PUC of the exchanged shares.

The bill amends section 84.1 by adding paragraph 84.1(2)(e), which applies where: (1) the exchanged shares are QSBC Shares or Farm or Fishing Shares; (2) the Purchaser Corporation is controlled by one or more adult children or grandchildren of the taxpayer; and (3) the Purchaser Corporation does not dispose of the exchanged shares within 60 months of the transaction. Where applicable, new paragraph 84.1(2)(e) will deem the taxpayer and the Purchaser Corporation to be dealing at arm's length such that subsection 84.1(1) should not apply to the disposition.

Bill C-208 also adds subsection 84.1(2.3) which is comprised of three paragraphs containing rules intended to backstop the application of new paragraph 84.1(2)(e). Proposed subsection 84.1(2.3) raises some interpretive challenges, some of which are attributable to the preamble of subsection 84.1(2.3) stating that subsection 84.1(2.3) applies only for the purposes of paragraph 84.1(2)(e).

Paragraph 84.1(2.3)(a) sets out the consequences that arise if the Purchaser Corporation sells the exchanged shares within 60 months after the acquisition. First, paragraph 84.1(2)(e) is deemed never to have applied. Second, the taxpayer is deemed for purposes of section 84.1 to have disposed of the exchanged shares to the person that acquired the exchanged shares from the Purchaser Corporation. Third, "the period of 60 months applicable to the operation that is deemed to have taken place [when the taxpayer is deemed to have sold the exchanged shares to the subsequent purchaser]" begins when the taxpayer disposed of the exchanged shares to the Purchaser Corporation.

The language of paragraph 84.1(2.3)(a) contains some peculiarities and ambiguities:

- Subparagraph (ii) states that it applies for purposes of the "section" while the preamble of subsection 84.1(2.3) states that the entire subsection applies for purposes of paragraph 84.1(2)(e). It is not apparent how this conflict should be resolved.
- If subsection 84.1(2.3) only applies for purposes of paragraph 84.1(2)(e), it is difficult to see how the taxpayer being deemed to have disposed of the exchanged shares to the subsequent purchaser has any effect on paragraph 84.1(2)(e). If the drafters intended that the deemed disposition would have tax consequences, the provision would have to apply for purpose of the Act or at least for purposes of Part I of the Act.
- It is not clear whether the deemed disposition to the subsequent purchaser is deemed to have happened in the year of the initial transfer to which subsection 84.1(1) would have applied but for the exception in paragraph 84.1(2)(e), or whether the deemed disposition to the subsequent purchaser is deemed to have happened in the year of the subsequent sale. Further, if the subsequent purchaser deals at arm's length with the taxpayer, does this mean that subsection 84.1(1) does not apply to either the deemed disposition to the subsequent purchaser or the initial transfer?
- The language "the period of 60 months applicable to the operation that is deemed to have taken place under subparagraph (ii)" is peculiar language but it seems obvious that it is referring to the deemed disposition to the subsequent purchaser. We suspect

that this awkward language is a product of parts of Bill C-208 being borrowed from Bill C-274 from the 42nd Parliament, which was sponsored by a francophone member (Guy Caron, NDP) and probably originally drafted in French.

- If a subsequent transfer occurs and the subsequent purchaser does not deal at arm's length with the taxpayer but is a corporation that is controlled by one or more adult children or grandchildren of the taxpayer, could the exception in paragraph 84.1(2)(e) apply to the deemed sale to the subsequent purchaser? If so, does the 60-month period restart or does the 60-month period continue from the date of the initial transfer? Proposed subparagraph 84.1(2.3)(a)(iii) could be interpreted to mean that the 60 month period continues from the date of the initial transfer.
- If a subsequent transfer occurs within 60 months but after the expiration of the normal reassessment period for the year of the initial transfer, it appears the CRA will in many cases be precluded from reassessing the taxpayer to apply subsection 84.1(1), notwithstanding that subparagraph 84.1(2.3)(a)(i) deems the exception in paragraph 84.1(2)(e) never to have applied.

Paragraph 84.1(2.3)(b) attempts to reduce the amount of the capital gains deduction (“CGD”) in subsections 110.6(2) or (2.1) where the Subject Corporation has taxable capital employed in Canada that exceeds \$10 million. However, the statutory language does not achieve this objective in any manner, and it is not clear in what circumstances the CGD grind is intended to apply. Further, it appears that the formula for the CGD grind has unintended consequences. The language of the provision raises the following questions and concerns:

- Paragraph 84.1(2)(e) has nothing to do with the CGD. Since subsection 84.1(2.3) only applies for purposes of paragraph 84.1(2)(e), the intended CGD grind in proposed paragraph 84.1(2.3)(b) has no effect on the amount of any taxpayer's CGD.
- Paragraph 84.1(2.3)(b) states that the CGD grind applies for a particular taxation year. This causes some challenges because the CGD is a cumulative lifetime deduction. Further, it is not clear which year should be the “particular taxation year”:
 - Is the CGD grind intended to apply only to a subsequent transfer? If so, that outcome is not achieved.
 - Is the CGD grind intended to apply to the initial transfer of the exchanged shares to which subsection 84.1(1) would have applied but for the application of proposed paragraph 84.1(2)(e)? Again, that outcome is not achieved.
- The formula in paragraph 84.1(2.3)(b) not only reduces the CGD for corporations with taxable capital employed in Canada that exceeds \$10,000,000, but also increases the CGD for corporations with taxable capital employed in Canada under \$10,000,000. It is not apparent that this consequence was intended. However, it is of no import since, as drafted, the paragraph has no effect on the CGD amount since it only applies for purposes of paragraph 84.1(2)(e).

- The formula in paragraph 84.1(2.3)(b) refers to “the corporation” without specifying which corporation is referred to. Presumably the provision is intended to refer to the Subject Corporation, but it is curious that the defined term was not utilized in this subsection after being defined in subsection 84.1(1).

It is conceivable that the purpose of paragraph 84.1(2.3)(b) is to limit the application of paragraph 84.1(2)(e) to transfers of QSBC Shares and Farm or Fishing Shares where the issuer has taxable capital employed in Canada of less than \$10,000,000. This objective would also not be achieved by the proposed legislation even if the scope of subsection 84.1(2.3) were not limited to paragraph 84.1(2)(e), since the amount of the CGD in subsections 110.6(2) or (2.1) is separate from the QSBC Share or Farm or Fishing Share definition in subsection 110.6(1).

Paragraph 84.1(2.3)(c) imposes reporting obligations. The provision requires that “the taxpayer must provide the Minister with an independent assessment of the fair market value of the subject shares and an affidavit signed by the taxpayer attesting to the disposal of the shares”. The language of this provision raises the following questions and concerns:

- Do these reporting obligations arise on the initial transfer of the exchanged shares by the taxpayer to the Purchaser Corporation to which subsection 84.1(1) would apply but for application of the exception in paragraph 84.1(2)(e) or do these reporting obligations only arise on the deemed disposition to a subsequent purchaser?
- What is the deadline for complying with the reporting obligations? What are the consequences for failing to satisfy the reporting obligations?
- What will constitute an independent assessment of the fair market value of the exchanged shares?
- Who is an appropriate third party to attest to the disposal of the exchanged shares and what knowledge of the relevant transactions must this person have?
- These reporting obligations appear more onerous than necessary. Why not create a prescribed form that contains information regarding the fair market value of the exchanged shares where the exception in paragraph 84.1(2)(e) is relied upon? If the prescribed form is required to be filed with the taxpayer’s return for the year in which the exception is relied upon, is not the certification that all information is correct and complete contained in the signature line of the return sufficient? It is not clear what the affidavit requirement contributes.

Conclusion

Bill C-208 includes amendments that go well beyond the summary of the bill provided. The amendments to paragraph 55(5)(e) and the addition of paragraph 84.1(2)(e) are relatively straightforward. However, it is unclear what the addition of subsection 84.1(2.3) is intended to accomplish and it is unlikely that any of the intended objectives are achieved by the language of the provision. It is possible that with added clarity regarding what subsection 84.1(2.3) is intended to accomplish, particularly with respect to

the CGD grind, the Department of Finance may be able to suggest amendments to the provision that assist it in technically achieving those outcomes.