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PRACTITIONERS' CORNER

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In this article, the authors discuss the Canadian Tax Court's recent *Poulin* and *Turgeon* decisions as they relate to navigating the arm's-length question of fact within the context of section 84.1 of the Income Tax Act (Canada).

Section 84.1 of Canada's Income Tax Act is an antiavoidance rule designed to prevent corporate surplus strips when an individual transfers shares of a corporation to another corporation. The section is renowned for being both a technical trap for the unwary and an uncertain quagmire for the vigilant. The latter occurs because section 84.1's application often turns on the elusive determination of a factual arm's-length relationship.

Poulin v. Queen and *Turgeon v. Queen*, 2016 TCC 154 (two cases heard on common evidence and culminating in a single decision by the Tax Court of Canada), is a particularly useful decision for helping practitioners and businesspeople navigate the ''arm's length'' question of fact within the context of section 84.1. The decision compares two slightly different scenarios, ultimately finding that section 84.1 applies to only one of the scenarios because the court determines that one transaction was not at arm's length while the other was.

The particular facts of each of Poulin's and Turgeon's transactions are extremely important to the outcome of the analysis. However, for the sake of brevity, this article will generalize them as follows:

1. Poulin and Turgeon (unrelated individuals) were the principal shareholders and operators of a Canadian corporation (Amiante).

2. Poulin and Turgeon decided to sever their relationship. Poulin would exit Amiante and Turgeon would control Amiante thereafter.

3. An Amiante employee (Hélie) would become a new minority shareholder of Amiante.

4. Poulin's exit from Amiante included a share sale to a holding corporation controlled by Turgeon (GT). If Poulin and GT did not deal at arm's length, the transaction would be subject to section 84.1.

5. During Poulin's exit from Amiante, Turgeon also undertook a share sale with a holding corporation controlled by Hélie (GH). If Turgeon and GH did not deal at arm's length, the transaction would be subject to section 84.1.

6. The consideration for Poulin's share sale to GT included a cash payment and debt that bore interest at 5 percent and was payable over a fixed period.

7. Turgeon's share sale to GH did not include cash consideration and the debt consideration issued bore interest at 4 percent with no fixed payment term.

8. The debt owed to Poulin was paid off. The debt owed to Turgeon had only partially been paid off at the time of the hearing.

9. GT and GH never received any dividends on the Amiante shares they purchased. Payments by GT and GH on their respective debts to Poulin and Turgeon were funded by Amiante share redemptions.

The Canada Revenue Agency reassessed Poulin and Turgeon by applying section 84.1 to deem that both received taxable dividends, rather than capital gains (and offsetting capital gains deductions), as a result of their respective dispositions to GT and GH. In the CRA's view, both dispositions were non-arm's-length transfers and met all of the other conditions of section 84.1. Specifically, the CRA asserted that GT and GH were simply acting as conduits, helping Poulin and Turgeon claim their capital gains deduction, while the companies themselves had no real interest in buying Amiante preferred shares, whose values were frozen, while incurring interest on the purchase price. Assuming it was correct, the reassessment would transform tax-free transactions into taxable ones because taxable dividends cannot be offset by the capital gains deduction.

The court analyzed Poulin's and Turgeon's dispositions separately. In both analyses, the court focused on whether the individuals and the holding corporations were acting in concert (that is, without separate interests) to determine if an arm's-length relationship existed. Two other tests — whether there was a common mind directing the bargaining for both parties and whether there was de facto control of one party over another — were not considered applicable under the circumstances. The court found that Poulin and GT dealt at arm's length; therefore, the reassessment was improper and section 84.1 did not apply. In contrast, the court upheld the CRA's reassessment and use of section 84.1 as applied to Turgeon because the court found that he did not deal at arm's length with GH.

The dichotomy between the ruling regarding Poulin and the holding as to Turgeon helps identify relevant factors for determining when parties are acting in concert, without separate interests as required by the factual arm's-length test. Two of the major factors influencing the court's view of the parties' own interests in the Poulin-GT sale versus the Turgeon-GH sale were:

- the payout term of the debt issued upon purchasing the preferred shares (fixed in the case of the Poulin-GT sale versus open-ended in the case of the Turgeon-GH sale); and
- whether the vendor remained involved with the subject corporation (Poulin's departure in the case of the Poulin-GT sale versus Turgeon remaining the controlling party of Amiante in the case of the Turgeon-GH sale).

In distinguishing between the two scenarios, it is helpful to consider the expression ''coming to the table,'' meaning willing to negotiate, versus ''happening at the table,'' meaning the negotiations themselves. The court seemed to focus on what brought the parties to the table, as opposed to what was discussed at the table.

In the case of the Poulin-GT sale, Poulin wanted to exit the company, extracting the most value possible from his shares along the way (thus, the fixed payout term of the debt). GT (and Turgeon, who controlled GT) was interested in the increased control and larger participating equity in Amiante that would result from Poulin's exit. Although the transaction analyzed was a purchase of preferred shares, this purchase formed part of a larger arrangement whereby Poulin exited the company as a common shareholder and employee. This is what brought each party to the table — differing interests. Therefore, an arm's-length relationship existed. It did not sway the court that once they were at the table, the parties were willing to work together to structure the transactions (which achieved their separate interests) to make the capital gains deduction available to Poulin.

The Turgeon-GH sale stands in contrast. GH's only reason for being at the table was accommodation. Its sole motivation for entering the transaction was to allow Turgeon to use the capital gains deduction while extracting corporate funds (as partly evidenced by the open-ended payout terms of the debt). Clearly, Turgeon came to the table for the same reason.

It is unlikely that a practitioner will find that a client's circumstances are identical to Poulin's or Turgeon's. However, in evaluating similar circumstances, it is important to ask: ''Is this more like a Poulin or a Turgeon scenario? Are there changes to the proposed structure that will make it more Poulin-like or less Turgeon-like?'' These questions will be particularly interesting in the context of ''Employee Buyco'' situations given the CRA's announcement[1] at the 2012 Canadian Tax Foundation National Conference that it may apply section 84.1 to those arrangements because of the degree of accommodation between the parties in those transactions. ◆

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[1]CRA Document 2013-0479402C6, ''Employee Buycos — Comments From CRA Panel'' (Nov. 25, 2012).