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PLANNING POSSIBILITIES RESULTING FROM CRA POLICY REVERSAL ON SECTION 84.1

At the 2019 APFF Table ronde sur la fiscalité fédérale, the CRA reconsidered its position on whether a deemed dividend under paragraph 84.1(1)(b) would generate a dividend refund.

Subparagraph 129(1)(a)(i) provides a refund of eligible or non-eligible refundable dividend tax on hand (RDTOH) in respect of eligible or non-eligible "taxable dividends paid by the corporation on shares of its capital stock in the year" at a rate of 38⅓ percent of the dividends paid. Paragraph 84.1(1)(b), when applicable, deems a dividend to be paid "to the taxpayer by the purchaser corporation and received by the taxpayer from the purchaser corporation." Because subparagraph 129(1)(a)(i) requires that the dividend be paid by the corporation on shares of its capital stock, the CRA has debated whether a paragraph 84.1(1)(b) deemed dividend would in fact be paid "on shares of its capital stock," which would then qualify for a dividend refund. This debate also applies to the capital dividend election under subsection 83(2), which requires that the dividend subject to the election be payable to "shareholders of any class of shares of its capital stock."

Initially, in TI 9729855 (January 19, 1998), the CRA opined that a dividend refund would be available in respect of a deemed dividend pursuant to paragraph 84.1(1)(b). However, the CRA changed its position in TI 2002-0128955 (September 26, 2002), where it disallowed a subparagraph 129(1)(a)(i) dividend refund and the subsection 83(2) election in respect of a section 84.1 deemed dividend. The CRA's rationale for the change was that the language in paragraph 84.1(1)(b) did not specifically state that a dividend was to be paid on shares of the corporation's capital stock. This was widely seen as an overly narrow interpretation: it causes tax non-integration, and the position that a dividend can be paid on anything except shares of the capital stock of a corporation was unconvincing.

At the 2019 APFF round table, the CRA said that a dividend refund can indeed be generated by the application of paragraph 84.1(1)(b). Although the CRA did not comment on its previous position on the subsection 83(2) capital dividend election, the same policy reversal should apply, since the underlying rationale was the same. At the Canadian Tax Foundation's 2019 annual conference, the CRA confirmed (at question 4 of the CRA Round Table) that a section 84.1 deemed dividend can benefit from both the paragraph 129(1)(a) dividend refund and the capital dividend account (CDA) mechanism.

The purpose of section 84.1 is to prevent the tax-free extraction of surplus from a corporation by an individual. Where the section applies, non-share consideration received by an individual may be recharacterized as a deemed dividend. Because section 84.1 applies only to non-arm's-length transactions, it is often of concern when an individual transfers shares of a private corporation to a personal holding company or sells shares of a private corporation to the holding company of a family member (including on generational transfers). The consequences of an unintentional triggering of section 84.1 could be dire: for example, the amount received on a transaction that utilizes the lifetime capital gains exemption on a sale could potentially be recharacterized as a taxable dividend of the full amount.

The CRA's policy reversal creates interesting tax-planning opportunities for individuals with private corporations. For example, section 84.1 may be used to recover a dividend refund or pay out a CDA balance from a corporation that cannot legally declare a dividend because of the applicable corporate law statute. Furthermore, the intentional triggering of section 84.1 on a sale may prove advantageous.

Consider, for example, a situation in which Bob holds all of the outstanding shares of Opco, with an FMV of $1 million and an ACB of $1. The shares are not QSBC shares. Bob receives an offer to sell all of his shares in Opco for $1 million in cash from a third-party purchaser. Ordinarily, Bob would realize a capital gain of $999,999 on the sale of the shares, which would result in approximately $240,000 of tax.

Alternatively, Bob could transfer 50 percent of his shares in Opco to a newly formed Holdco on a rollover basis. Holdco subsequently triggers a gain on the Opco shares (for example, by using an internal section 85 share exchange), resulting in a $500,000 capital gain on which Holdco pays approximately $127,000 of corporate tax while generating $250,000 in the CDA and $77,000 of non-eligible RDTOH.

Bob then sells his remaining $500,000 of Opco shares to Holdco in two tranches of $250,000 for promissory notes, at which point section 84.1 deems both payments of $250,000 to be dividends. Pursuant to subsection 83(2), Bob elects to treat the first dividend of $250,000 as a capital dividend, resulting in no further tax to him. The second dividend of $250,000 is considered a taxable dividend sufficient to generate a dividend refund that fully recovers Holdco's $77,000 of non-eligible RDTOH.

Finally, Holdco sells the shares of Opco to the third-party purchaser for $1 million cash without incurring an additional gain (because Holdco has full tax basis in the shares). Holdco then transfers $500,000 of this cash to Bob tax-free as a repayment of the promissory notes. As a result of these steps, the following tax consequences arise:

1. Bob is deemed to have received a dividend of $250,000, all of which is declared to be a capital dividend and not subject to tax.
2. Bob is deemed to have received another dividend of $250,000, which is taxed at Bob's marginal rate. Assuming a 41 percent rate, this amounts to $102,500 in personal tax.
3. Holdco has net corporate tax of $50,000 after the dividend refund ($127,000 − $77,000) and is left with $450,000 of after-tax cash.

The total tax is $152,500 rather than $240,000 because there is a deferral of tax until further dividends are paid from Holdco. However, careful advisers will consider whether in any individual case there is a risk of the CRA's invoking GAAR or another anti-avoidance provision, such as subsection 129(1.2).

Absent legislative changes, the CRA's present position with respect to a dividend refund and section 84.1 opens up

planning opportunities for individuals with private corporations. But planners should be aware of the associated risks and should consider whether the additional tax benefits outweigh those risks or whether more traditional sale-planning techniques are preferable.

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