Capital Gains Strips – How to do it and How Risky is It

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2020 TSG Conference

Presented by

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(with thanks to Kenneth Keung)

Capital Gains Strips – How to do it and How Risky is It

Agenda

- Background
- Recent Case Law and CRA Technical Interpretations
- Potential Budget Changes
- Capital Gains Strips Planning Examples:
  - Accelerated Capital Gains (while hedging your bets)
  - Use of Accommodating Party
  - Appreciated Property and Existing Retained Earnings
  - QSBC Share Surplus Strip

Capital Gains Strips – How to do it and How Risky is It

Background – Capital Gains versus Dividend Rates

- **BC 2019 Tax Rates for Illustration Purposes**:
  - Personal Capital Gains Rate 24.9%
  - Personal Ineligible Dividend Rate 44.64%
  - Personal Eligible Dividend Rate 31.44%
  - Capital gains are taxed at a lower rate than corporate dividends in the hands of individuals
  - Therefore, instead of paying a dividend, extract funds from the corporation by triggering a capital gain (“surplus stripping”)

Capital Gains Strips – How to do it and How Risky is It

Background – Legislative Limits to Surplus Striping

- **ITA 84.1**:
  - Prevents non-arm's length surplus stripping with tax-free adjusted cost base ("ACB") (either via V-Day or the lifetime capital gains exemption ("LCGE"))
  - The CRA attempted to restrict surplus stripping beyond ITA 84.1, but case law generally indicates that there is no overall scheme in the Act against surplus stripping (e.g. Gwartz)

Capital Gains Strips – How to do it and How Risky is It

Background - Legislative Limits to Surplus Striping

- **2015 CTF Roundtable Question 4**:
  - The CRA is asked whether the General Anti-Avoidance Rule ("GAAR") applies to a triggering of s.55(2) capital gain by intentionally no filing a 55(5)(f) designation, in order to generate capital dividend account ("CDA") to surplus strip
  - The CRA response, citing:

  Although the GAAR Committee considered that the Transactions circumvented the integration principle, it recommended that the GAAR not be applied. The GAAR Committee was of the view that it would be unlikely that the GAAR could be successfully applied to the Transactions given the current state of the jurisprudence. It was also recognized that results similar to those obtained from the Transactions could be achieved in a variety of ways.

  - Paragraph 55(5)(f) is since amended to make the designation automatic, but the underlying message that the Act has no overall scheme against capital gain surplus tripping still holds.

Capital Gains Strips – How to do it and How Risky is It

Background - Legislative Limits to Surplus Striping

- **ITA 84(2):**
  - Imposes dividend treatment where corporate property distributed or otherwise appropriated in any manner whatever to or for the benefit of the shareholders, on the winding-up, discontinuance or reorganization of its business
  - Potentially applies to inter-vivos or post-mortem pipeline
  - 2013 Federal Court of Appeal decision of Macdonald
  - CRA accepted post-mortem pipeline on case-by-case basis: cannot be 'cash box', Opco's business continues >1 year followed by a progressive distribution

Capital Gains Strips – How to do it and How Risky is It

Background - Legislative Limits to Surplus Striping

- **Retrospective – July 18 Proposal Surplus Strip Rule**
  - July 18, 2017 budget originally proposed changes to section 84.1 and the introduction of an anti-avoidance provision under 246.1
  - If implemented, would likely have completely eliminated surplus stripping as a tax planning tool
  - Federal government announced on October 19, 2017 that they were no longer moving forward with either of the changes

Review of S. 84.1 and July 2017 Proposed Changes (Abandoned)

- The basic conditions for ITA 84.1(1) applying are:
  - An individual resident in Canada disposes of shares that are capital property (the "**taxpayer**");
  - The shares being disposed of are shares of a corporation resident in Canada (the "**subject corporation**");
  - The disposition is made to another corporation (the "**purchaser corporation**") with which the taxpayer does not deal at arm's length; and
  - Immediately after the disposition, the subject corporation is connected to the purchaser corporation (pursuant to ITA 186(4) and 186(2)).
- If conditions are met, potential consequences are 84.1(a) paid-up capital ("**PUC**") grind and/or 84.1(1)(b) deemed dividend.

Review of S. 84.1 and July 2017 Proposed Changes (Abandoned)

- 84.1(1)(a) functions as a PUC grind. If new shares of the purchaser corporation were issued as consideration for subject shares, then PUC of the issued shares are reduced by:

  (A – B) * C / A

  - Where A is the increase in PUC of all shares of the purchaser corporation as a result of the issuance of the new shares.
  - Where B is the greater of:
    - PUC of the subject corporation's shares, immediately before their sale.
    - ACB of the subject corporation's shares to the taxpayer immediately before their sale, excluding the 1972 V-Day value and LCGE on the calculation of ACB.
  - Where C is the increase in PUC of the particular class of shares as a result of the issue of the new shares.

"Hard basis" of subject shares

Review of S. 84.1 and July 2017 Proposed Changes (Abandoned)

- 84.1(1)(b) deems a dividend to be paid from the purchaser corporation to the taxpayer equal to:

$$(A + D) - (E + F)$$

Total tax basis received

- Where A is the increase in PUC of all shares of the purchaser corporation before the application of 84.1(1)(a).
- Where D is the fair market value (“**FMV**”) of non-share consideration, other than the new shares, received by the taxpayer from the purchaser corporation for the subject shares.

“Hard basis” of subject shares plus 84.1(1)(a) PUC Grind

- Where E is the greater of:
  - The PUC of the subject shares immediately before their sale.
  - The ACB of the subject shares, immediately before their sale, excluding the 1972 V-Day value and LCGE on the calculation of the ACB.
- Where F is the PUC grind calculated in 84.1(1)(a)

Review of S. 84.1 and July 2017 Proposed Changes (Abandoned)

ACB modification clause in ITA 84.1(2)(a.1)

Applies even if Opco shares acquired on arm's length transaction

… where a share disposed of by a taxpayer was acquired by the taxpayer after 1971 ~~from a person with whom the taxpayer was not dealing at arm's length~~, was a share substituted for such a share or was a share substituted for a share owned by the taxpayer at the end of 1971, the ACB to the taxpayer of the share at any time shall be deemed to be the amount, if any, by which its ACB to the taxpayer, otherwise determined, exceeds the total of …

(ii) the total of all amounts each of which is an amount determined after 1984 under subparagraph 40(1)(a)(i) in respect of a previous disposition of the share or a share for which the share was substituted ~~(or such lesser amount as is established by the taxpayer to be the amount in respect of which a deduction under section 110.6 was claimed)~~ by the taxpayer or an individual with whom the taxpayer did not deal at arm's length;

ACB is reduced by any capital gain previously reported by taxpayer or a non-arm's length individual after 1984 in respect of the share or a substituted share !!

Proposed amendment was effective for dispositions occurring after July 17, 2017

Review of S. 84.1 and July 2017 Proposed Changes (Abandoned)

- Proposed ITA 246.1:
  - If as part of a series of transactions:
    - A resident individual receives an amount, directly or indirectly, from a non-arm's length individual; and
    - There was a property disposition or increase/decrease in PUC; and
    - It is reasonable to consider that one purpose of the series of transactions was to significantly reduce assets of a private corporation in a manner, as a result of the distribution of corporate property, that avoids taxes otherwise payable by the individual.
  - Amount received by individual becomes a deemed dividend.
  - Also, any capital gains derived from the series of transactions are precluded from the capital dividend account.

Capital Gains Strips – How to do it and How Risky is It

Recent Case Law and CRA Technical Interpretations

- Descarries 2014 TCC 75 and 2015 CTF Conference – CRA Roundtable – Q11
- Pomerleau 2016 D.T.C. 1206
- CRA Technical Interpretation 2016-0625001E5
- Take Aways:
  - Surplus stripping directly or indirectly using 'soft basis' will be caught under either section 84.1 or GAAR
  - Surplus stripping with tax-paid ACB appears to be acceptable to the Courts

Capital Gains Strips – How to do it and How Risky is It

Recent Case Law and CRA Technical Interpretations

- Four “hall marks” suggested by DOF:
  - Ceasing Control of Business
  - Children to Continue long-term operation of business
  - No continuing financial interest
  - No further participation in management

Capital Gains Strips – How to do it and How Risky is It

Recent Case Law and CRA Technical Interpretations

- Joint Committee’s submission critical of DOF’s strict conditions
- CALU’s submission looked at Quebec’s new rules & US rules
- CALU suggested their own “hallmarks”

Capital Gains Strips – How to do it and How Risky is It

Potential Budget Changes

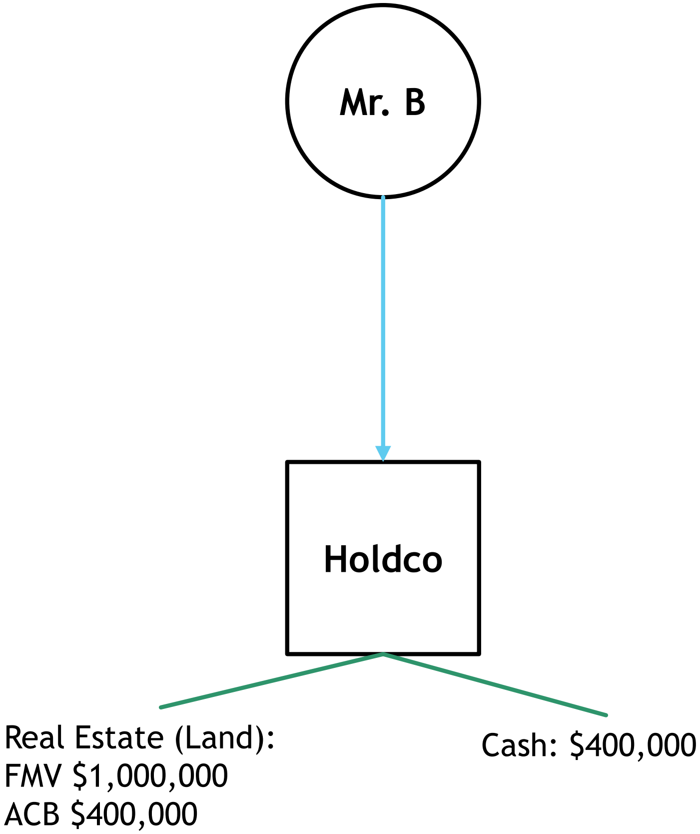
- Reinstate July 18, 2017 Proposals?
- Increase Capital Gains Inclusion Rate:
  - Increase from 50% to 2/3rd's inclusion (24.9% to 33.2%)
  - Increase from 50% to 75% inclusion (24.9% to 37.4%)

Capital Gains Strips – How to do it and How Risky is It

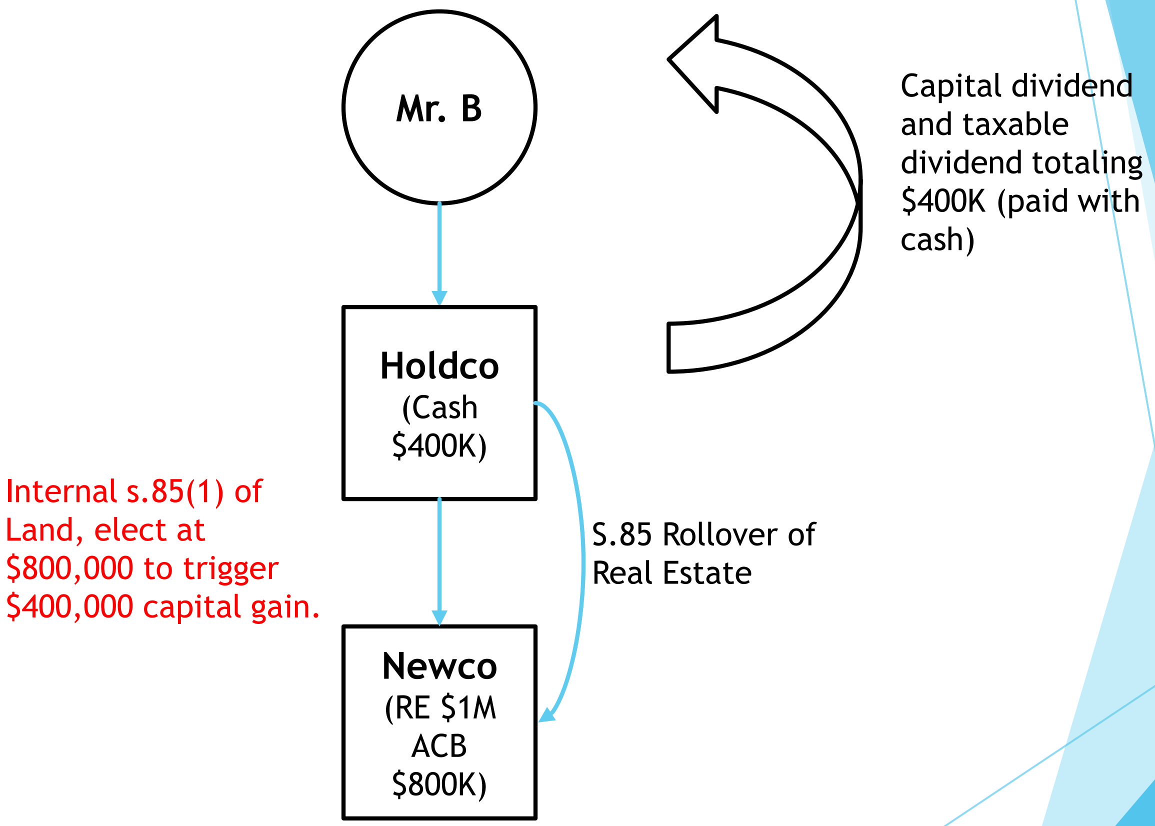
Capital Gains Strips Planning Examples – Accelerated Capital Gains

- Accelerate sale of corporate (or personal) assets to prior to 2020 Federal Budget
  - Anticipated sale of asset within one year anyways?
  - Transfer of Assets to corporation (corporate or personal) pursuant to Section 85 prior to Budget:
    - Trigger capital gains using elected amount if rates increase
    - Elect at cost if rates do not increase
    - Higher corporate capital gains (27.86%) rate versus personal (24.9%)
    - Filing deadline April 30, 2021 (cover two budgets?)

Capital Gains Strips Planning Examples – Accelerated Gain in Corporate Assets



Capital Gains Strips Planning Examples – Accelerated Gain in Corporate Assets

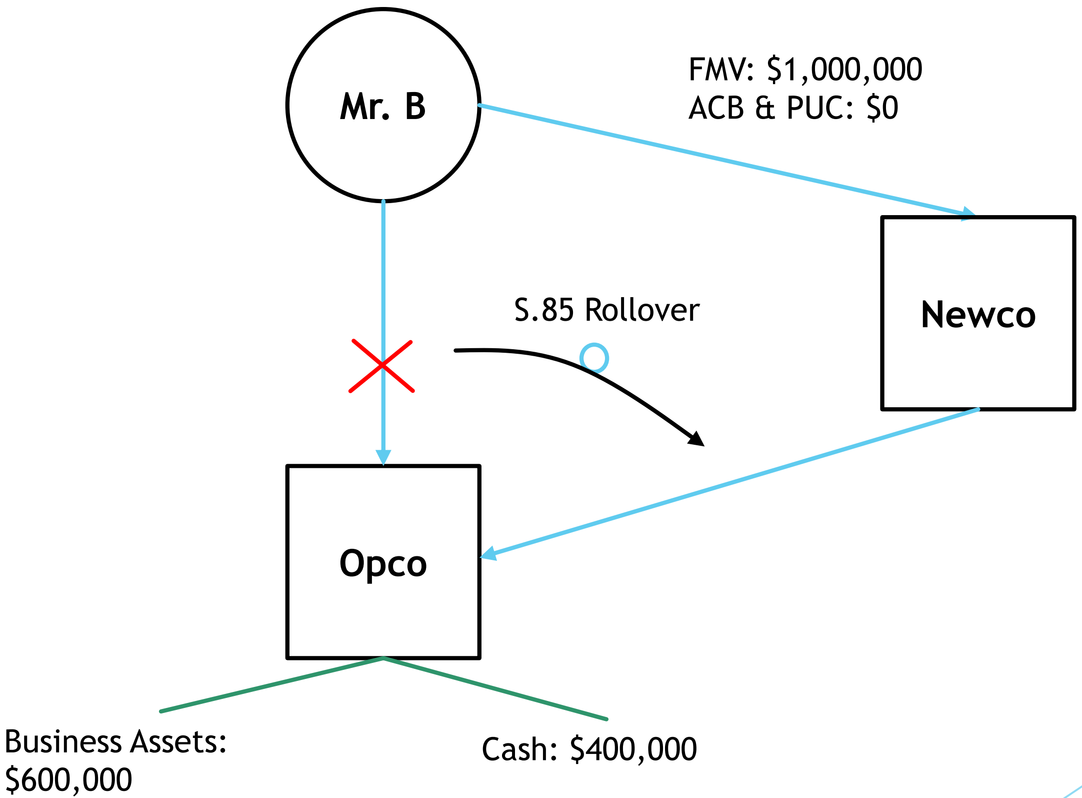


Capital Gains Strips – How to do it and How Risky is It

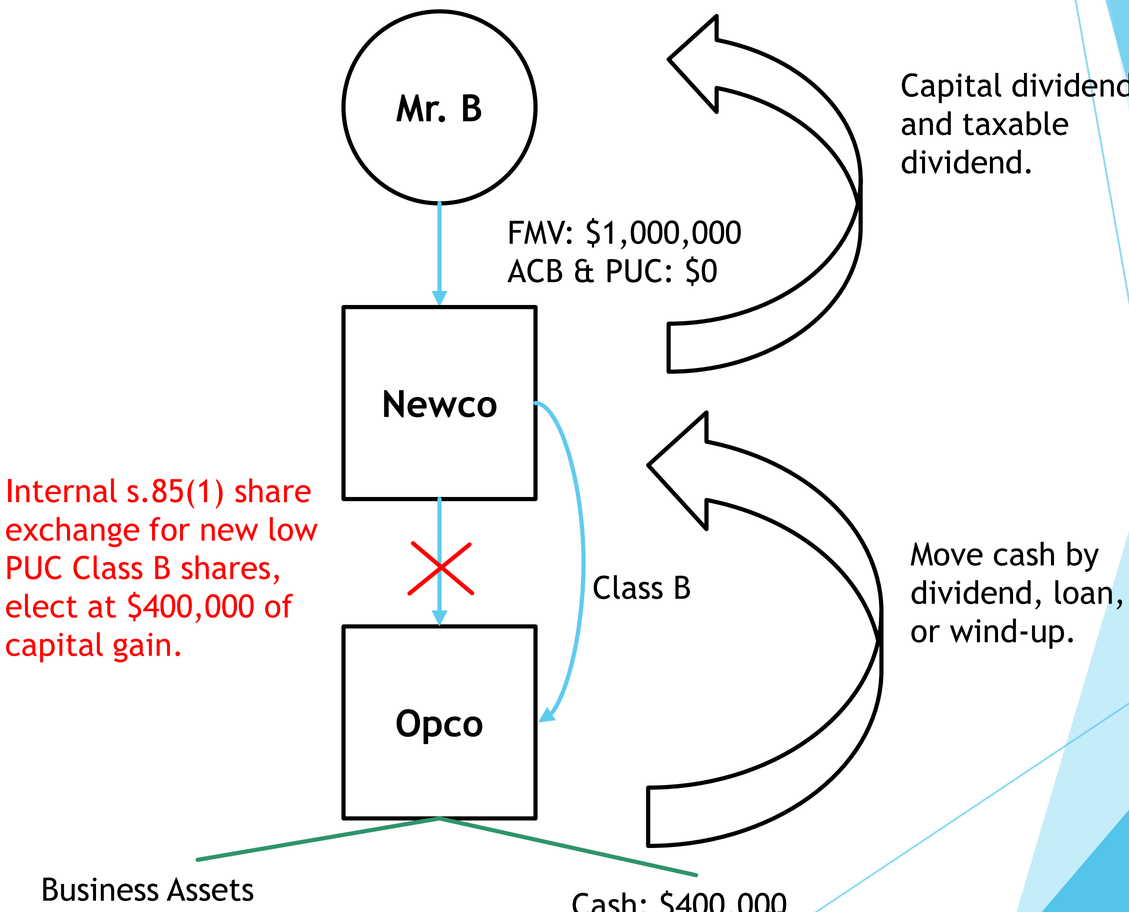
Capital Gains Strips Planning Examples – Accelerated Gain in Corporate Assets

- Results:
  - Corporate capital gains tax triggered on a flow through basis rather than dividend rates (27.86% versus 31.44% or 44.64%)
  - Increased cost base of corporate assets
    - Watch out for recapture on depreciable assets
  - Bare Trust arrangement to mitigate PTT for real estate? Could just sell portfolio investments.
  - Plan timing of filing and elected amount relative to any Federal budget changes

Capital Gains Strips Planning Examples – Accelerated Gains in Shares of Company (Plan A)



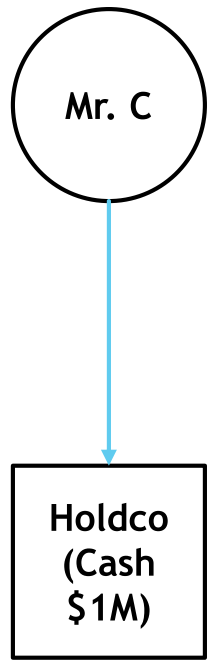
Capital Gains Strips Planning Examples – Accelerated Gains in Shares of Company



Capital Gains Strips Planning Examples – Accelerated Gains in Shares of Company

- Results:
  - No deemed dividend on share exchange because PUC remains low.
  - Newco recognizes $400,000 capital gain and triggers CDA and RDTOH.
  - Mr. B receives $200,000 of tax-free capital dividend from CDA, and approximately $200,000 of ineligible dividends to recover RDTOH.
  - Effective tax rate of 27.86% on a flow through basis to extract $400,000 of cash (potential for lower rate see Plan B re accelerating gain in personal shares).

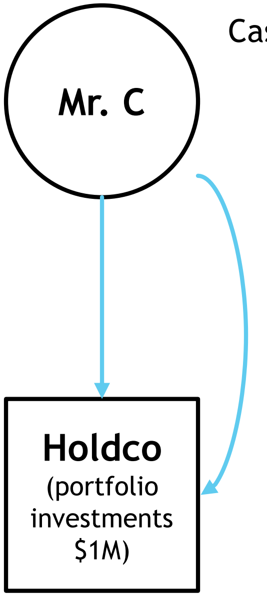
Capital Gains Strips Planning Examples – Accelerating Capital Gain in Personal Assets



Portfolio
Investments:
FMV $1,000,000
ACB $400,000

Capital Gains Strips Planning Examples – Accelerating Capital Gain in Personal Assets

Cash $1,000,000



Transfer portfolio investments to Opco for Class B shares with PUC equal to elected amount or P-Note, elect at $1M $600,000 of capital gain.

$1,000,000 P-Note or shares with $1,000,000 PUC.

Mr. C recognizes $600,000 of capital gain and pays personal tax on capital gain. PUC paid out with corporate cash.

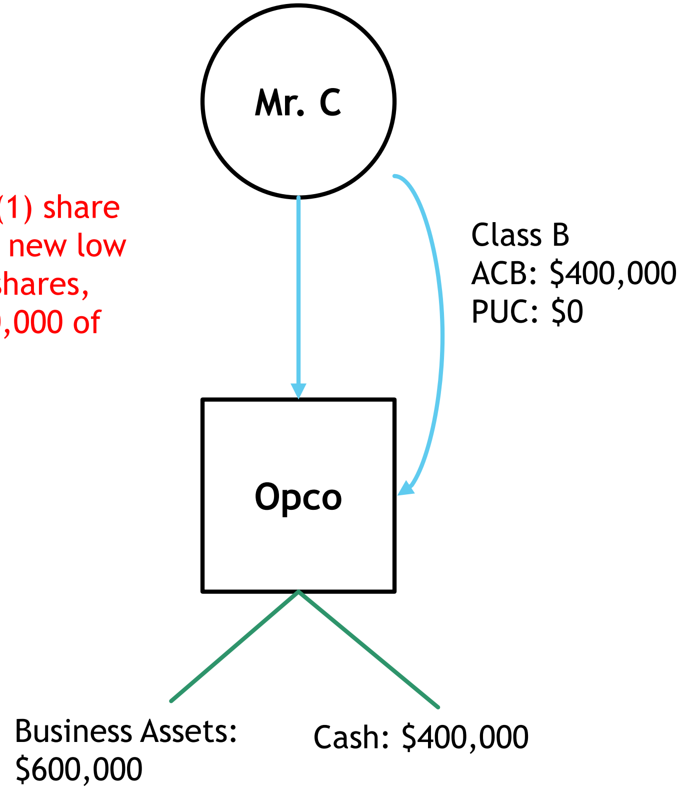
Capital Gains Strips – How to do it and How Risky is It

Capital Gains Strips Planning Examples – Accelerating Capital Gain in Personal Assets

- Results:
  - Extract $1M cash from company at 24.9% rather than dividend rates (44.64% or 31.44%)
  - Watch out for higher corporate capital gains rates on future appreciation of portfolio investments (27.86% versus 24.9%)
  - Plan timing of filing and elected amount relative to any Federal budget changes (say April 30, 2021 for potential two years of budgets)

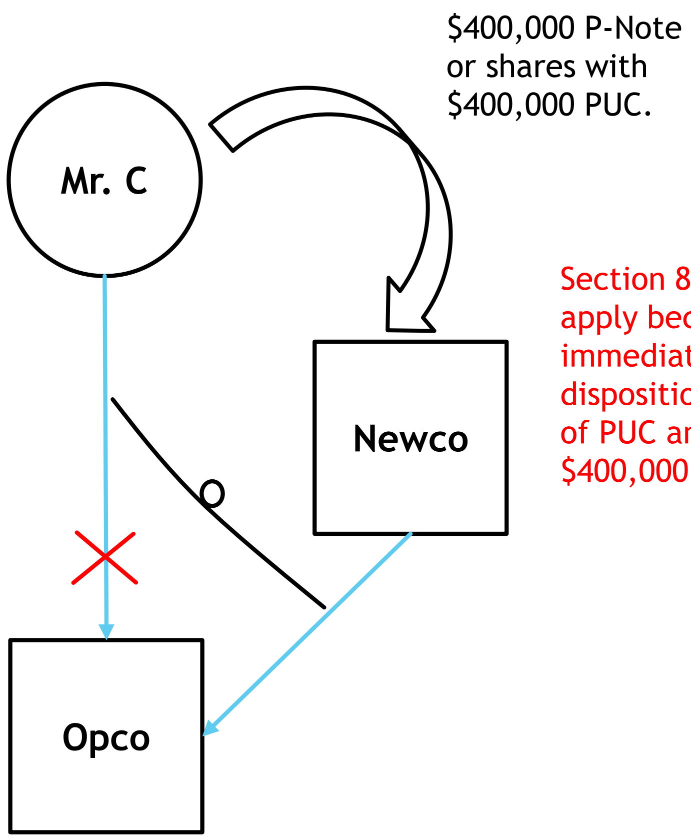
Capital Gains Strips Planning Examples – Accelerating Capital Gain in Personal Shares (Plan B)

Internal s.85(1) share exchange for new low PUC Class B shares, elect at $400,000 of capital gain.



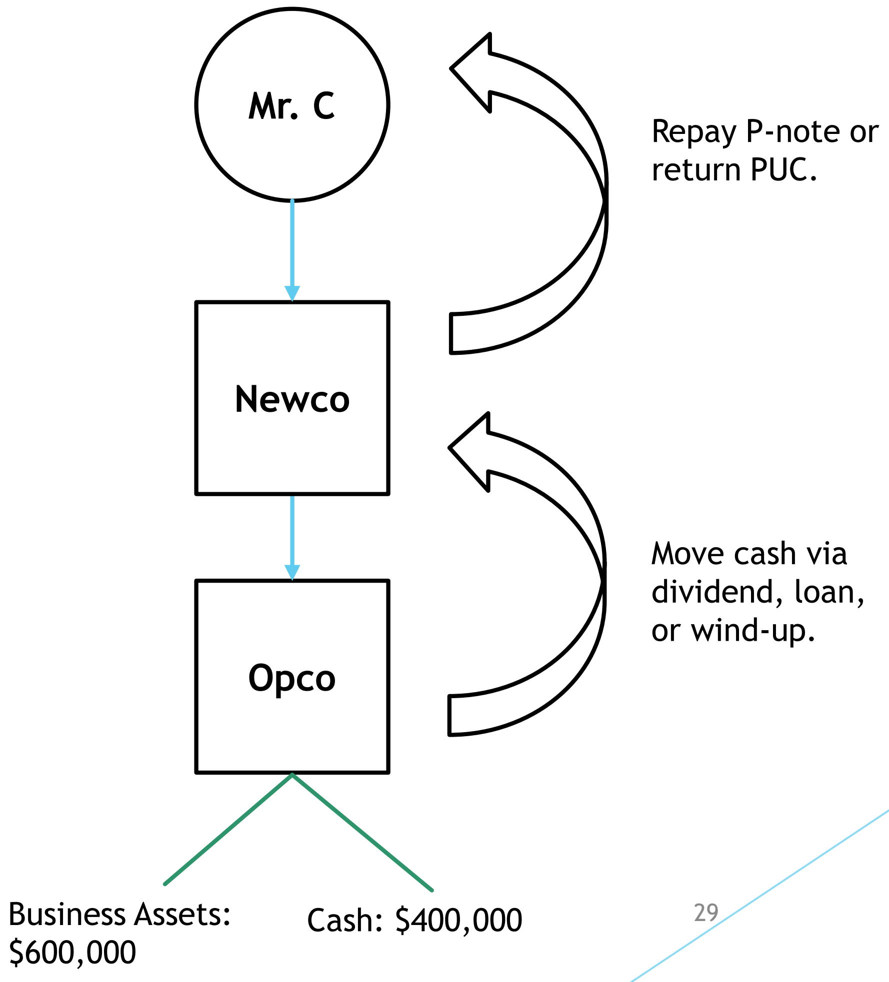
Mr. C recognizes $400,000 of capital gain and not claim LCGE. Pays personal tax on capital gain.

Capital Gains Strips Planning Examples – Accelerating Capital Gain in Personal Shares (Plan B)



Section 84.1 will not apply because immediately before the disposition the greater of PUC and hard ACB is $400,000.

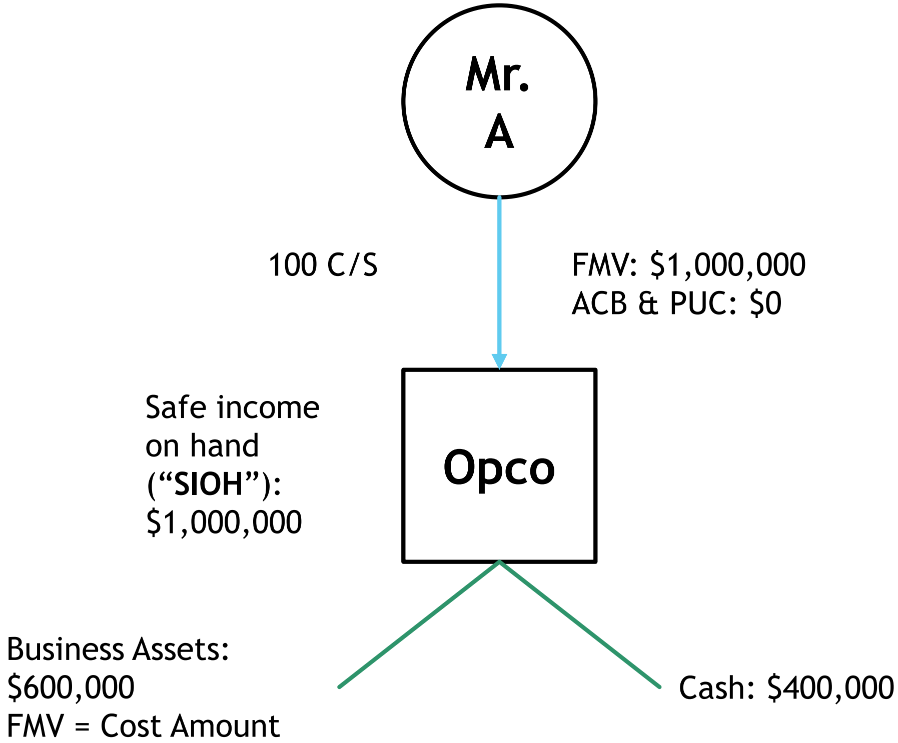
Capital Gains Strips Planning Examples – Accelerating Capital Gain in Personal Shares (Plan B)



Capital Gains Strips Planning Examples – Accelerated Gains in Shares of Company

- Results:
  - No deemed dividend on share exchange because PUC remains low.
  - Mr. C recognizes $400,000 capital gain pays personal tax.
  - Cash extracted via promissory note or PUC on a tax free basis.
  - Effective tax rate of 24.9% to extract $400,000 of cash (versus 27.86% on a flow through basis in Plan A).

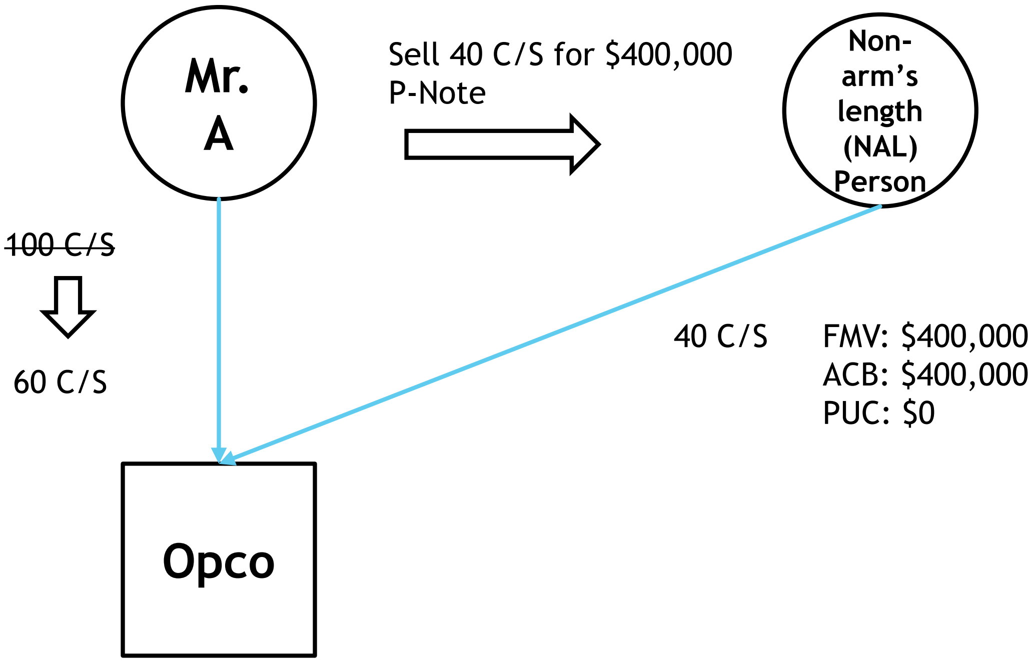
Capital Gains Strips Planning Examples - Use of Accommodating Party



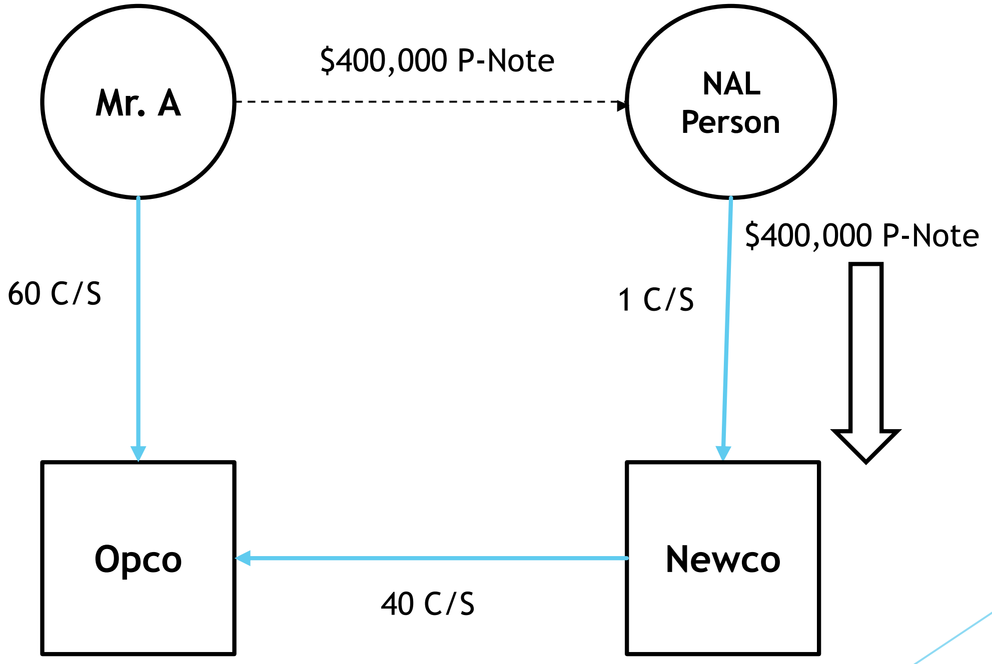
Objective: Withdraw $400,000 cash tax efficiently.

Base case: $400,000 of dividend subject to tax between 31% to 45%.

Capital Gains Strips Planning Examples - Use of Accommodating Party

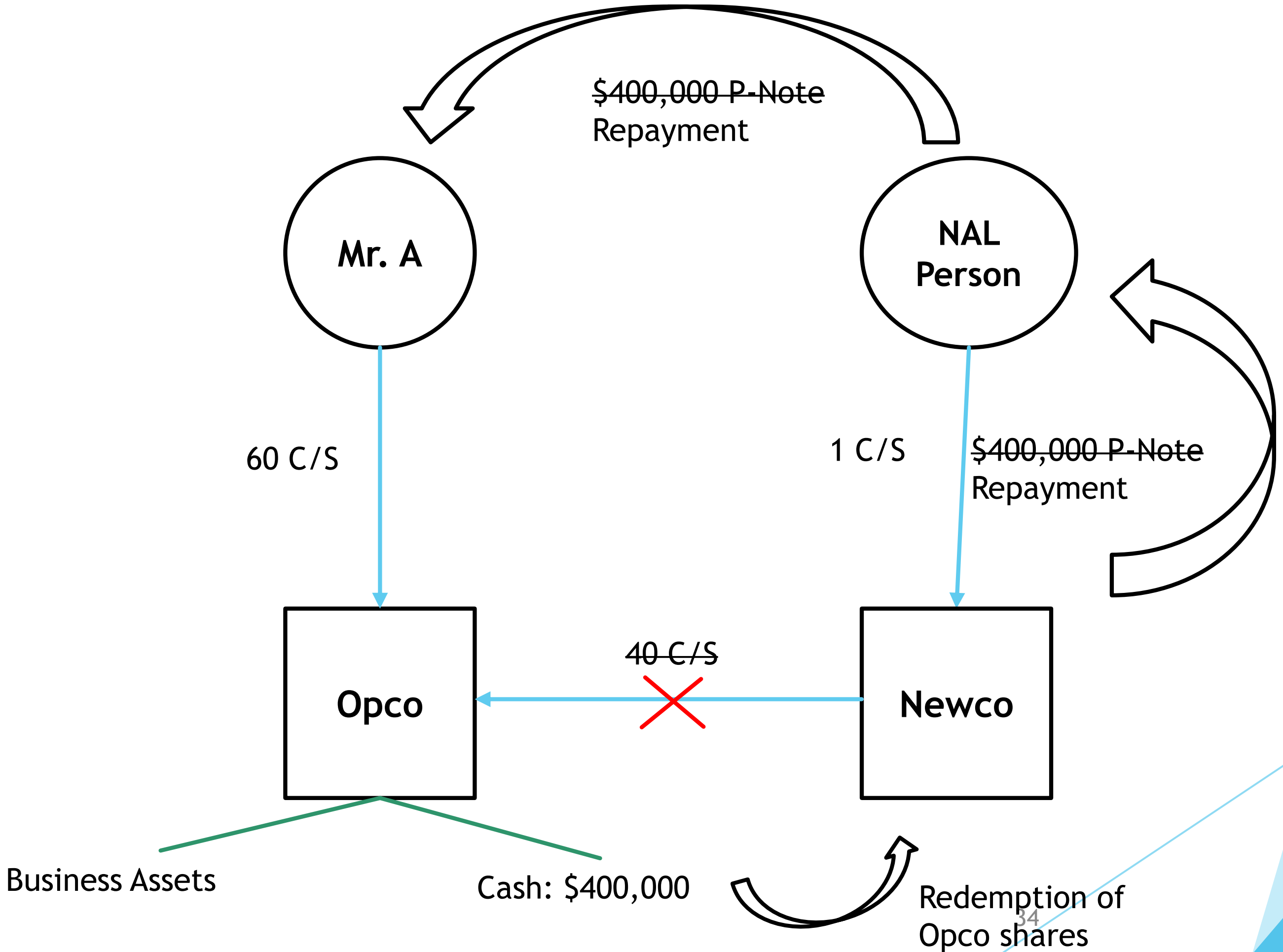


Capital Gains Strips Planning Examples - Use of Accommodating Party



S84.1 does not apply to deem any dividend to the non-arm's length person because the 40 Opco C/S has $400,000 of tax-paid hard basis.

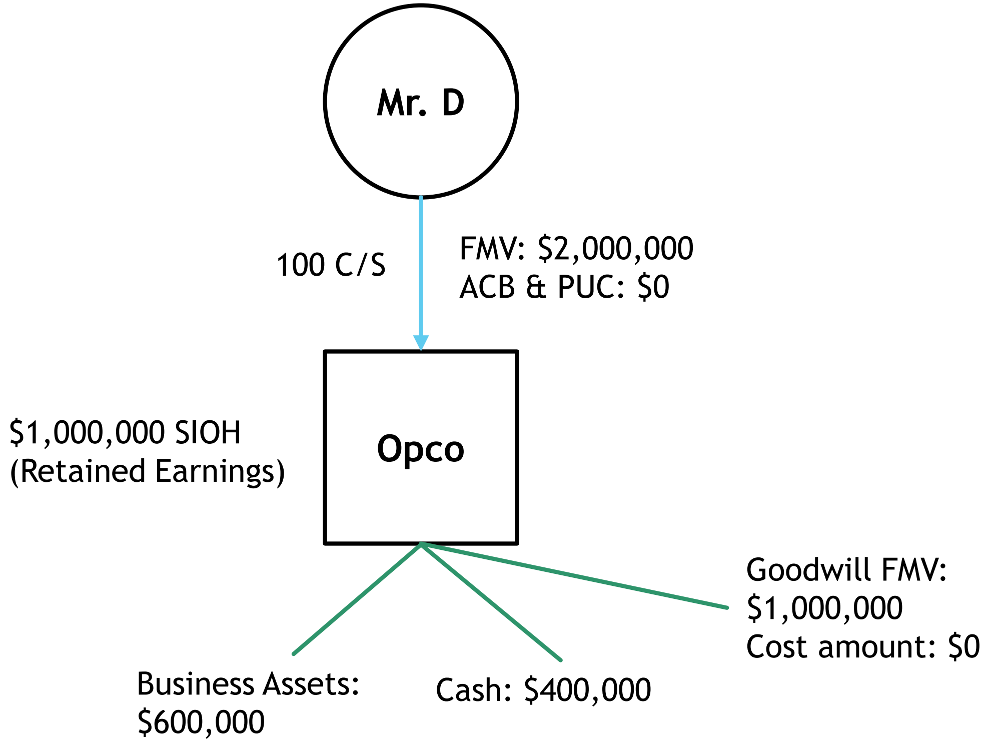
Capital Gains Strips Planning Examples - Use of Accommodating Party



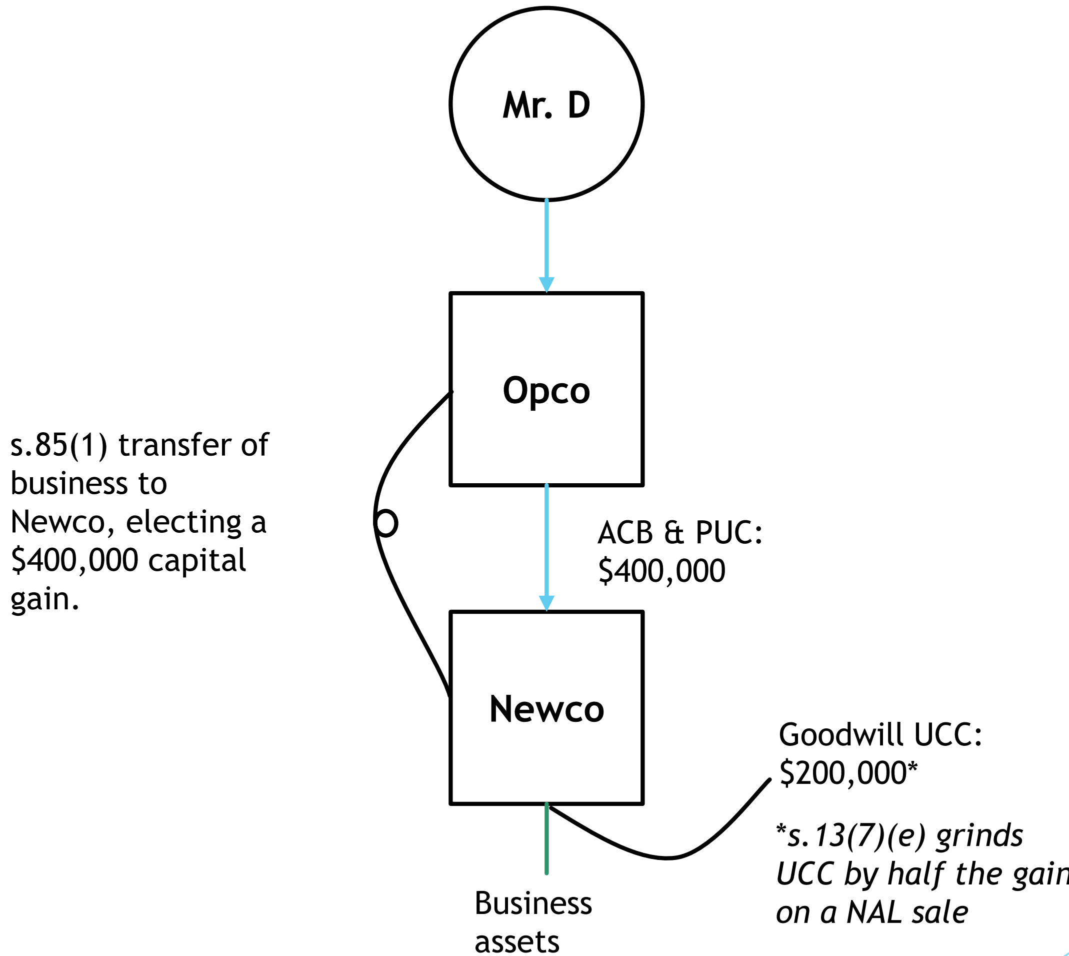
Capital Gains Strips Planning Examples - Use of Accommodating Party

- Result:
  - Extracted $400,000 cash at capital gains rate, i.e. 24.9%
  - Redemption of Opco shares result in subsection 84(3) deemed dividend.
  - No Part I income tax because of subsection 112(1) and because 55(2) will not apply since the redeemed shares have full ACB (and because of sufficient SIOH).
  - No Part IV tax because Newco and Opco are connected.

Capital Gains Strips Planning Examples - Corporate Appreciated Property and Existing Retained Earnings



Capital Gains Strips Planning Examples - Corporate Appreciated Property and Existing Retained Earnings



Opco recognizes $400,000 capital gain; pays corporate tax (generates CDA and RDTOH). Opco pays capital and ineligible taxable dividends)

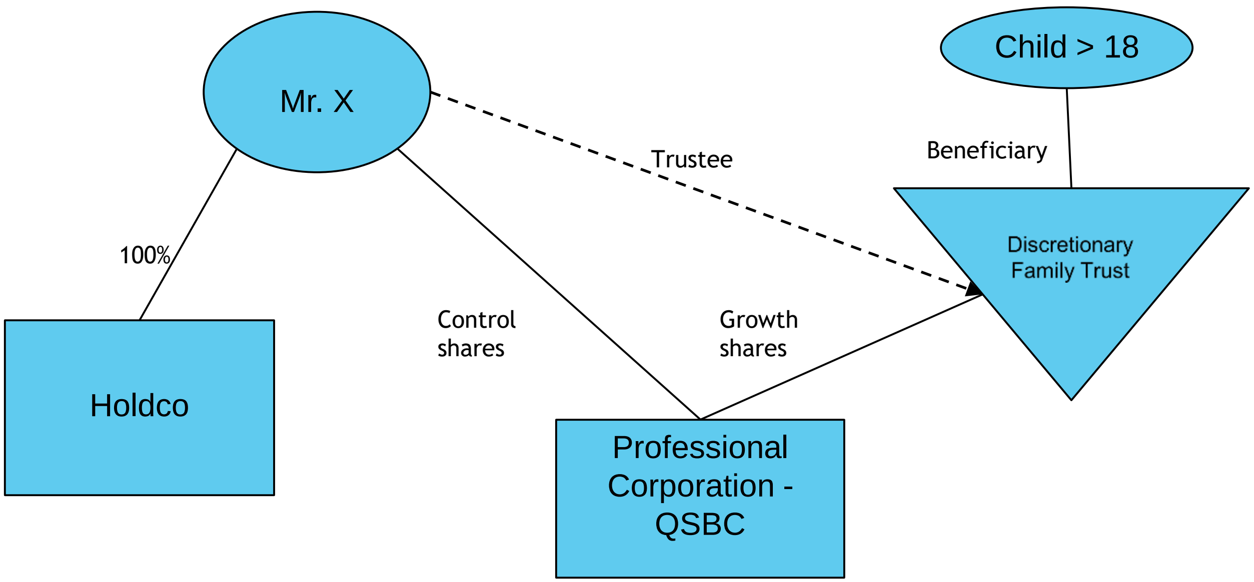
Mr. D pays Personal tax on ineligible dividend

Effective tax rate on a flow through basis of 27.86%.

In addition, UCC of $200,000 available for future CCA claims.

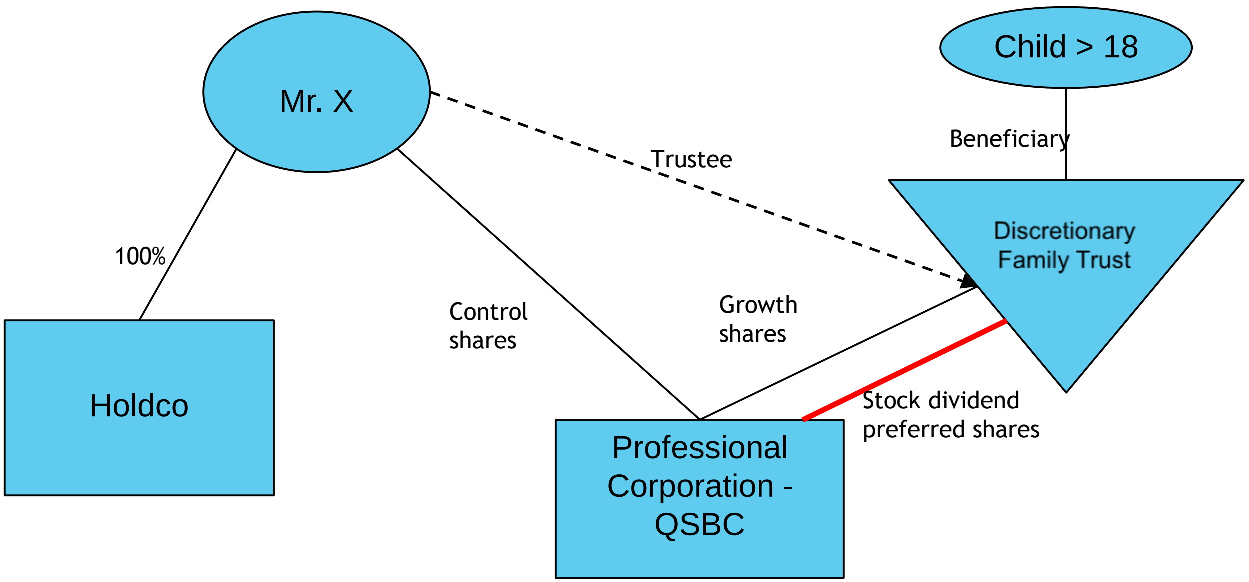
Note that if Newco borrowed to acquire business, the interest will be deductible and the cash can be used for distribution.

Capital Gains Strips Planning Examples - QSBC Share Surplus Strips



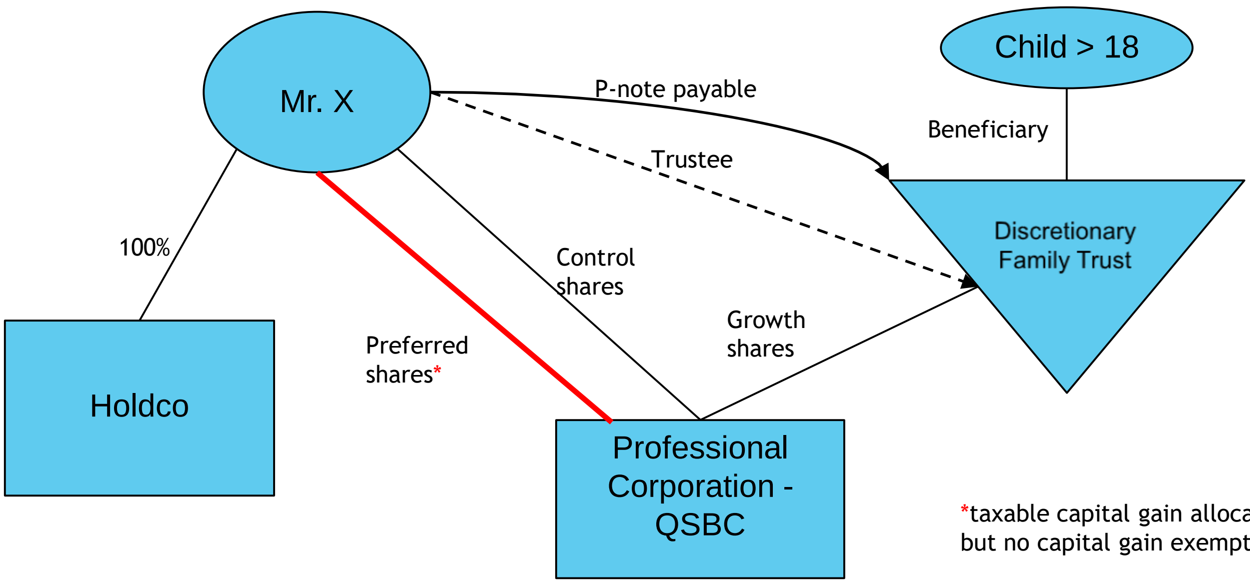
Capital Gains Strips Planning Examples - QSBC Share Surplus Strip

Preferred share stock dividend to trust



Capital Gains Strips Planning Examples - QSBC Share Surplus Strip

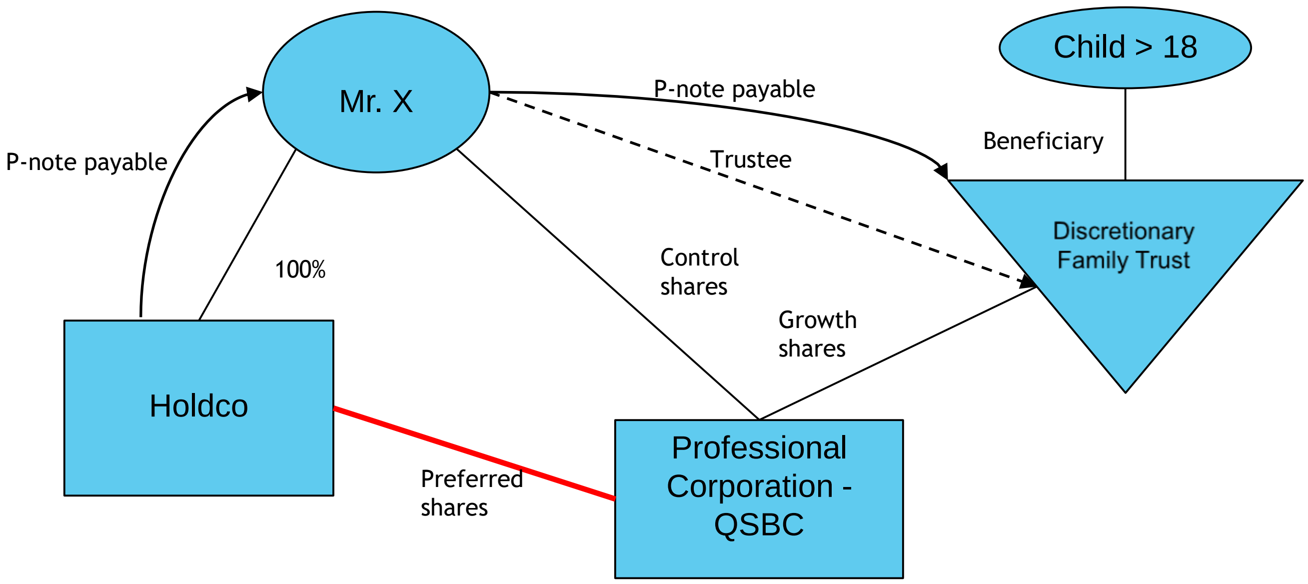
Preferred shares sold by Trust to Mr. X for a promissory note



*taxable capital gain allocated to child but no capital gain exemption claimed

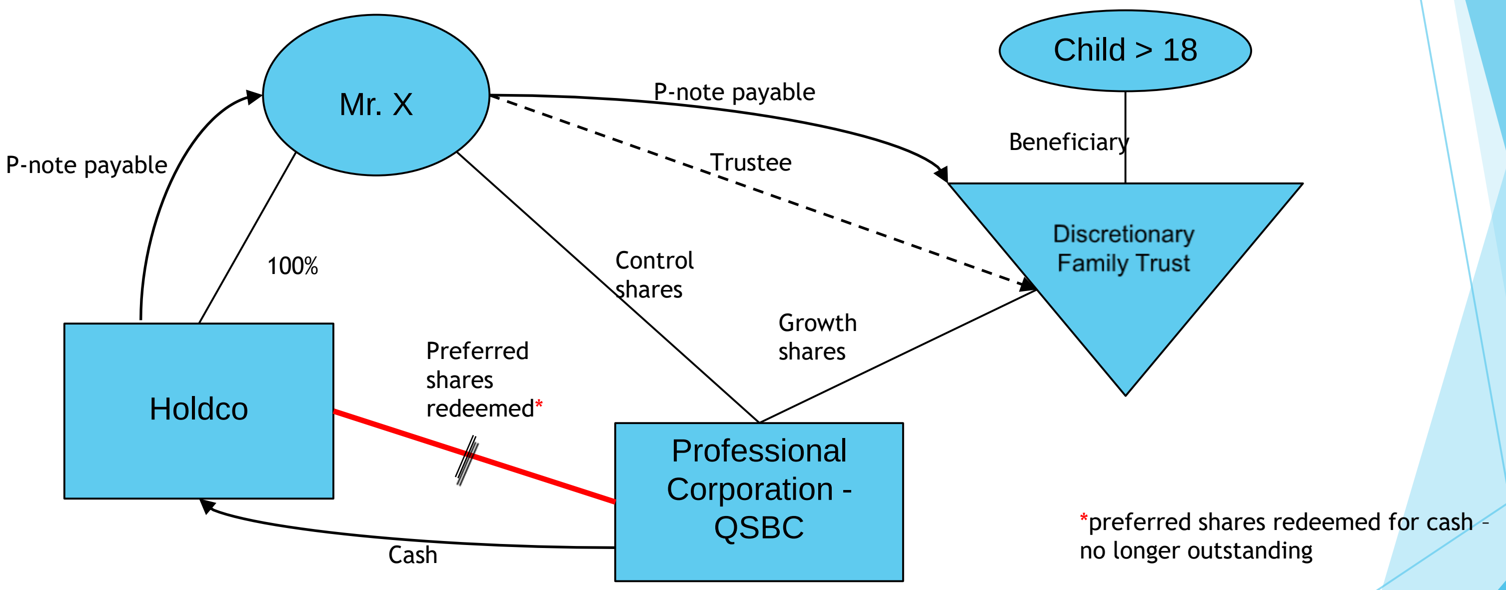
Capital Gains Strips Planning Examples - QSBC Share Surplus Strip

Preferred shares sold by Mr. X to Holdco for a promissory note



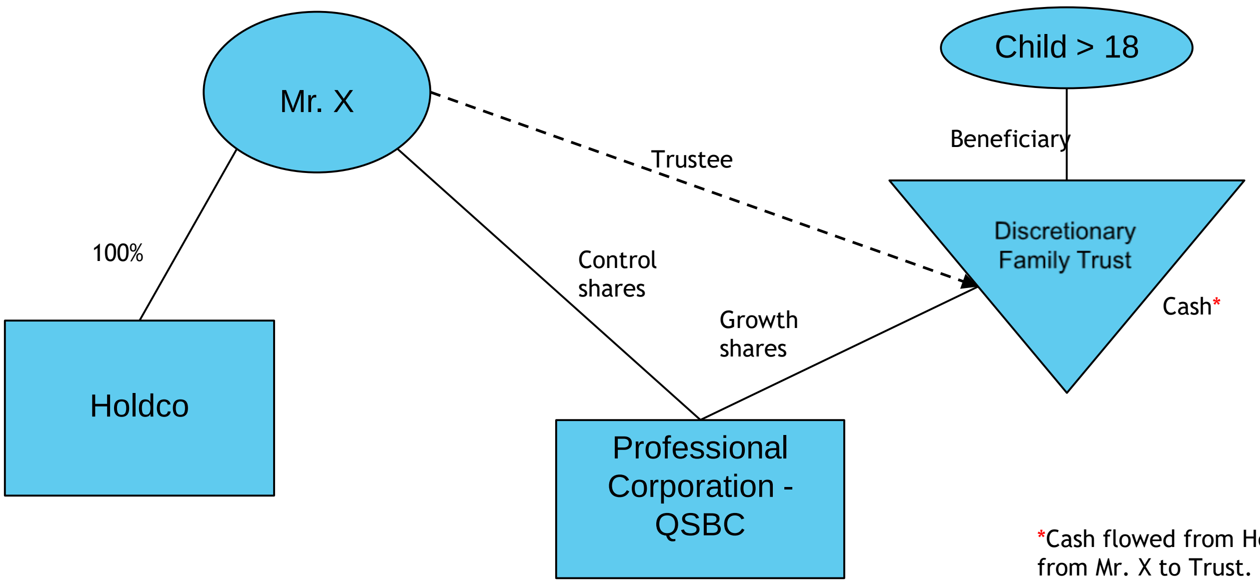
Capital Gains Strips Planning Examples - QSBC Share Surplus Strip

Preferred shares redeemed for cash



Capital Gains Strips Planning Examples - QSBC Share Surplus Strip

Both promissory notes repaid



*Cash flowed from Holdco to Mr. X and from Mr. X to Trust. 50% of cash owing to Child

Capital Gains Strips Planning Examples - QSBC Share Surplus Strip

- Shares may qualify as QSBC shares regardless of type of business
- May consider corporate beneficiary to permit regular purification of the operating company
- GAAR challenge may be difficult for CRA without legislative amendments

Capital Gains Strips – How to do it and How Risky is It

Questions?