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Tax strategies for the high-net-worth family

Steve Landau, Toronto

Adapted and updated from an article written for Advisor.ca

No two family scenarios are the same, and this is especially true when it comes to very wealthy families.

Your wealth may come from a successful business, an inheritance, a wise investment or other sources. You may have children or others who depend on you for support, at different ages and stages of life. Your personal and family values and wealth-succession objectives will also be unique. You may have done no planning, or you may already have implemented some planning involving wills, holding companies or trusts.

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One thing, however, is common among high-net-worth families: they face a variety of wealth-related issues that require professional advice, with particular focus on reducing taxes.

A comprehensive tax plan can reduce your overall family tax burden, both during your lifetime and on death. In this article, we provide a primer of frequently applied techniques, including income splitting, trusts, insurance and will planning.

Income splitting

Despite extensive attribution rules designed to prevent the splitting of family income with lower-taxed family members, there are still some opportunities to do so.

A prescribed-rate loan, for example, can be made to a lower-taxed family member, or to a trust for the benefit of several family members, with the income on the invested proceeds being taxed at the lower tax rate applicable to the borrower. Provided the loan requires interest to be paid, and is paid to the lender at the prescribed rate set by the government, there's no attribution of the net income back to the lender. (The prescribed rate is set quarterly, and for the fourth quarter of 2016 is 1%.)

These types of loans can be made to a spouse, adult children or trusts for minor children and grandchildren. The advantage of using a trust where several family members are beneficiaries is that there can be flexibility as to the distribution of income. This can also be an effective way to fund education costs. The income from the loan proceeds can fund their tuition, books, other school activity costs and other personal expenses.

And the loan can always be repaid to the lender and the income-splitting arrangement reversed if the tax results are no longer advantageous.

Often, wealthy individuals assume responsibility for helping other family members in need, whether parents, grandparents or others. Typically, an outright gift will be made to the recipient, funded by after-tax dollars. A more tax-effective way to fund such a gift is to make an income distribution to that relative through a trust, the income from which can be paid to the relative-beneficiary, deducted from the income of the trust and taxed at the lower tax rate that applies to the individual.

If there are disabled children for whom a disability tax credit is claimed, a preferred beneficiary designation can be made. That designation allows income to be allocated and taxed in the hands of the preferred beneficiary without having to make an actual distribution to that person.

When implementing these strategies, however, you need to bear in mind that many lower-income members of the extended family qualify for other income-tested benefits. For example, splitting income with a disabled relative may impair their eligibility for certain tax benefits. Older relatives can lose access to the Guaranteed Income Supplement, or see their Old Age Security benefits clawed back. Young families can lose access to the Canada Child Benefit. Often, these benefits, plus the lower-income earner's lower tax bracket, result in an aggregate cost in excess of the top personal tax rate.

Incorporation of investment portfolios

With recent increases in personal tax rates, depending on your province of residency, it may be advisable to transfer a personally held investment portfolio to a family holding company. Tax rates for investment income earned in a holding company can be somewhat lower than the top personal tax rate before giving consideration to any additional net tax liability on distribution.

If a family trust becomes a shareholder of the holding company, dividends can be paid to the family trust generating a refund of a portion of the tax otherwise payable by the corporation on that income.

If these dividends are allocated to adult children (18 years and older) or other adult family members who may be in a much lower marginal tax bracket, the tax payable on the receipt of these dividends may be substantially lower than the tax refunded to the corporation.

If the income is allocated to trust beneficiaries with limited or no other income (or who have tuition credits etc.) there may be no tax payable on the allocated dividends, resulting in the corporation paying less than 40% of the tax that may have otherwise been payable on the investment income earned by an individual in the top tax bracket.

The investments may be transferred to the corporation on a tax-deferred basis with a promissory note issued by the company as payment for the original cost of the investments. Preferred shares of the holding company would be issued for the balance of the value of the transferred investments. Cash can be extracted from the company on a tax-free basis by repaying the promissory note as needed.

Salaries and dividends

In the right circumstances, such as if you own and operate a business, it may be possible to employ family members and pay them salaries for services rendered to the business. The salary paid, however, must be reasonable for the services actually provided.

If the business is operated through a corporation, it's also possible to pay dividends on shares held by, or for the benefit of, adult low-tax-rate family members. In that case, the shareholders don't have to render services to the corporation, and they can receive dividends in their capacity as shareholders.

Different classes of shares can be issued to different family members and the dividend rights can be discretionary. This will allow for the payment of dividends on some classes of shares and not on others, enabling the streaming of dividends to those shareholders who need the funds and who will pay tax on the dividends at a lower rate. However, the attribution rules must be considered if the shareholders do not purchase their shares with their own funds or with funds borrowed from an arm's-length lender.

Trusts

The high-net-worth family will be as interested in deferring tax as in saving tax — and trusts are often a useful means of doing so.

Normally, the transfer or disposition of property will occur at fair market value, triggering the realization of accrued gains in the property. However, when property is transferred between spouses or common-law partners, or to special types of trusts for the benefit of a spouse or common-law partner, the tax realization is deferred. Any tax on accrued gains will only be payable when the property is actually sold, or upon the death of the surviving spouse or partner.

Note, though, that while a spouse or partner trust can achieve a significant deferral of tax, it may also allow the high-net-worth taxpayer to retain some measure of control and decision-making over the property in the trust, provided the broad attribution rules don't apply. The trust can provide a scheme of distribution (whether fixed or flexible) that can remain in place long after the trust is established.

Generally, there's a tax realization or deemed disposition on any accrued gains or losses in the trust every 21 years following its formation. Keep this 21-year rule in mind if you implement any tax-planning structures involving trusts.

Will planning and death

You should seek advice on how the family wealth should be distributed when you die, and regularly monitor the advice in light of your changing personal circumstances.

It's essential that you have a will that's fairly current — and possibly more than one will to deal with different types of assets and jurisdictions.

In cases where provincial probate tax is applicable, and may be significant, probate tax reduction strategies should be considered. This may involve transferring assets, such as the family cottage or non-appreciated assets, to a family or alter ego trust, with the effect that the transferred asset won't be owned by an individual on death.

It may also be effective to use multiple trusts to address different types of assets, thereby shielding certain assets from the probate tax net.

A trust established under a will is a testamentary trust that will be taxed in a more favourable way than an inter vivos trust for a limited period of time. An inter vivos trust is taxed at the top marginal tax rate on every dollar of income, while a testamentary trust enjoys the graduated rates of tax for the first 36 months following the death of the individual. Under new rules the limited time period for the graduated rates is only available to a single trust created on each death.

Insurance

Even when the tax on death has been deferred and minimized, there will be a tax burden to satisfy at some point, and the family will have to plan for that eventual liquidity call.

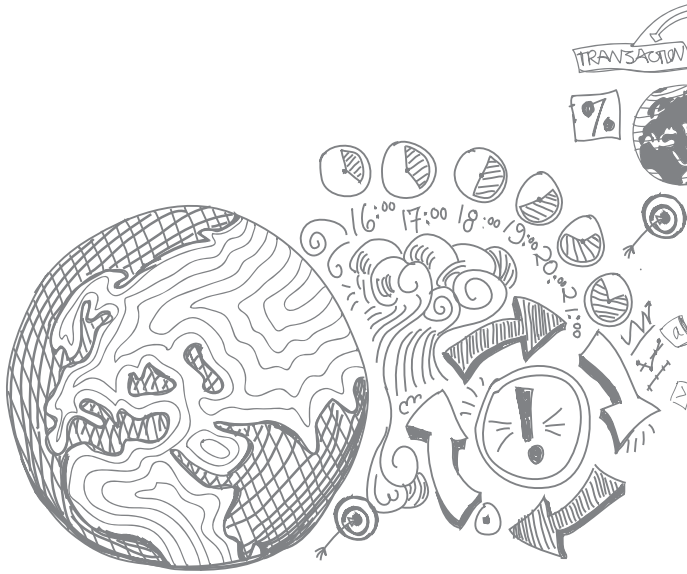
Well-planned insurance strategies — such as joint-last-to-die policies that pay the death benefit on the second-to-die of the spouses or life-insured annuity contracts that provide the necessary liquidity at the right time — can be put in place to provide tax-sheltered investment return, estate preservation and liquidity to pay the ultimate tax burden.

If the insurance policy is owned by the corporation, the death of the insured will trigger payment of the death benefit. Most of this death benefit is added to a surplus account, called the capital dividend account, which can be distributed to shareholders on a tax-free basis. If the insurance proceeds are used to redeem or buy back shares held by the estate, the insurance can be used not only to fund the tax payable on death, but also to reduce the net tax payable, leaving more insurance money for the estate beneficiaries.

Keep in mind, though, that this redemption planning must be completed within the first year following the death of the insured person.

Plan well for today and tomorrow

All Canadians owe it to themselves and their families to regularly review their lifetime and estate financial plans. It's important to be aware of opportunities to reduce or defer tax. However, these opportunities may not fit all situations. You should seek professional advice when selecting those that are right for you. ◆



Changes to the principal residence exemption and reassessment of real estate dispositions: how will they impact you?

Maureen De Lisser and Yves Plante, Toronto

On 3 October 2016, federal Finance Minister Bill Morneau announced a number of financial and tax-related measures to help ensure Canada has a healthy, competitive and stable housing market. Included in the announced changes are measures aimed at closing loopholes surrounding the exemption from capital gains tax on the sale of a principal residence (also known as the "principal residence exemption"), as well as measures extending the reassessment period on real estate dispositions. While some of the principal residence exemption measures are specifically targeted at nonresidents who purchase homes in Canada and certain trusts, other measures apply more broadly to all Canadian homeowners.

Principal residence exemption

The following is a summary of the key changes related to the principal residence exemption.

- **Canadian homeowners:** Beginning with 2016, all Canadian homeowners will be required to report the sale of a principal residence on their tax return for the year in which the sale occurred; those who do not will be subject to an extended reassessment period. A further amendment will also permit the Canada Revenue Agency to accept a late-filed principal residence designation (subject to a late-filing penalty). These measures apply for taxation years that end on or after 3 October 2016. Therefore, individuals will be required to report all principal residence dispositions occurring in the 2016 calendar year (not just those occurring on or after the 3 October 2016 announcement date) and subsequent years. See discussion below for more details on this change.
- **Nonresidents moving to Canada:** The principal residence exemption formula allows an individual to shelter a capital gain that has accrued on a principal residence for "one plus" the number of years the qualifying property is designated as the individual's principal residence and during which the individual was resident in Canada. Because it is common for an individual to sell a home and immediately purchase another in the same calendar year, the "one plus" rule ensures that the individual isn't taxed on a portion of the gain that may accrue during the year in which both the old and new properties are owned. However, the extra year of exemption room created by the "one plus" rule unintentionally allowed an individual to benefit from the principal residence exemption for a taxation year during which the individual was not resident in Canada. For dispositions occurring on or after 3 October 2016, the "one plus" rule will no longer apply for principal residences acquired in a taxation year during which the individual was not resident in Canada at any time in the year.
- **Principal residences held through a trust:** For trust taxation years that begin after 2016, new rules will apply to limit the types of trusts that are eligible to designate a property as a principal residence. These new rules are intended to better align trust eligibility criteria with situations in which a principal residence is held directly by an individual. Therefore, in addition to restricting the types of trusts that are eligible to claim the principal residence exemption, the new rules require that at least one of the beneficiaries be resident in Canada during the year that the property is designated as a principal residence.

For further discussion on the changes affecting nonresidents and trusts, see EY Tax Alert 2016 Issue No. 45, *Proposed amendments to principal residence exemption rules for trusts and nonresidents*.

Extended reassessment period for real estate dispositions

New rules will permit the CRA to assess a taxpayer's tax return outside the normal reassessment period if the taxpayer (or a partnership of which the taxpayer is directly or indirectly a member) does not report the disposition of real property in the taxpayer's (or partnership's) return for the year of disposition. If the return is subsequently amended to report the disposition, the CRA may assess or reassess the taxpayer's return within three years after the day on which the amended return (or prescribed form amending the return) is filed. Where this rule applies to permit the CRA to issue an assessment or reassessment outside of the normal reassessment period, the assessment may only be made to the extent it can reasonably be regarded as relating to the real property disposition.

This new rule, which is not limited to principal residence dispositions, generally applies to individuals, trusts, corporations and partnerships. However, these new rules do not apply where:

- The taxpayer is a real estate investment trust
- In the case of a disposition by a corporation or partnership, the real property is not held as capital property (i.e., these rules do not apply to real property dispositions that result in business income, rather than a capital gain or capital loss)

This new rule applies for taxation years that end on or after 3 October 2016.

Implications for individuals disposing of a principal residence

When an individual resident in Canada sells or is deemed to have disposed of a home that qualifies as the individual's principal residence, the individual typically does not have to pay tax on the gain. This is the case if the home was the individual's principal residence for every year the individual owned it. However, for 1982 and later years, a family unit may designate only one home as the family's principal residence for each year. A family unit generally includes the individual, the individual's spouse or common-law partner, and any of the individual's unmarried children under the age of 18.

Where an individual sells a property that was not designated as a principal residence for every year of ownership (such as may be the case where an individual owns more than one residence, such as a city home and a cottage), the portion of the capital gain that relates to the years the individual did not designate the property as a principal residence may be taxable.

Administratively, the CRA has not required individuals to report the disposition of a principal residence on their tax return if the gain was fully sheltered by the principal residence exemption (i.e., the property qualified as the individual's principal residence for every year of ownership). This administrative practice may have allowed situations to go undetected where an individual has inappropriately benefited from the principal residence exemption, whether unintentionally due to the complexity of the rules, or intentionally (such as in situations involving real estate flips). The changes announced on 3 October 2016 mark the end of this administrative practice.

For 2016 and later years, individuals must report all principal residence dispositions occurring in the year, or be subject to an extended reassessment period in respect of the property disposition. The CRA has published *new guidance* on its website explaining how individuals should report the disposition:

- Where the property is designated as the individual's principal residence for each year of ownership (i.e., such that the gain is fully sheltered), the principal residence designation is to be made directly on Schedule 3 of the *T1 Income Tax and Benefit Return*

for the year. The individual will report only the year of acquisition, proceeds of disposition, and a description of the property.

- Where the property is not designated as the individual's principal residence for each year of ownership, the individual will be required to file a completed Form T2091 (IND), Designation of a Property as a Principal Residence *by an Individual (Other Than a Personal Trust)*, with his or her return for the year (any capital gain remaining after applying the principal residence exemption must be reported on Schedule 3 of the individual's tax return).

As indicated above, an individual will be able to amend a tax return to subsequently report a principal residence disposition, and limit the extended reassessment period to three years after the date the amended return is filed (unless there has been a misrepresentation attributable to neglect, carelessness, wilful default or fraud in filing the return or in supplying information under the Income Tax Act). A related amendment will now permit the CRA to accept a late-filed principal residence designation, subject to the normal penalty for late-filed elections. The penalty is equal to the lesser of $100 per month that the designation is late and $8,000.

As a result of these new reporting requirements and the extended reassessment period, it will be very important for individuals (particularly those who own more than one residence in a year) to properly track the cost of each residence and determine how best to allocate the principal residence exemption among multiple properties. The cost of each property will generally be equal to the original purchase price plus the cost of all capital improvements made to the property. Properly tracking the cost of the property and maintaining appropriate records (i.e., purchase agreement, receipts and invoices) to support the cost will help to minimize any capital gain that may arise if the property cannot be fully sheltered by the principal residence exemption.

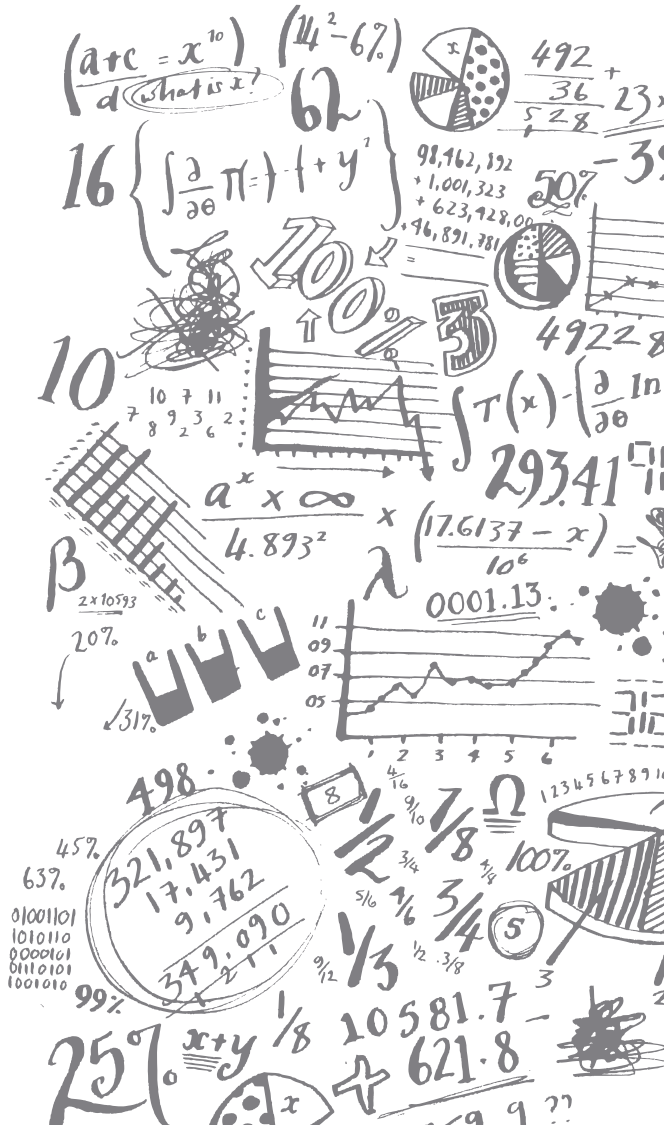
Other complexities apply for properties owned continuously since before the end of 1981, or for which there has been a change in use from personal to business or rental use (or vice versa), that may require the individual to determine the fair market value of the property on 31 December 1981 or on the date of a change in use, and calculate a notional gain (or loss) on that date.

Important compliance actions

For 2016 and later years, taxpayers and partnerships who dispose of any real estate should ensure the disposition is reported on their tax return for the year of disposition. If the principal residence exemption is being claimed by an individual to shelter a capital gain on the disposition, the individual should report the disposition on Schedule 3 of his or her income tax return for the year. In addition, where applicable, the individual should also complete Form T2091 (IND) to designate the property as a principal residence and calculate the amount of any capital gain remaining after the exemption (after having properly tracked its cost). Form T2091 (IND) should be attached to the individual's tax return for the year.

If the disposition is not reported, then, upon audit, the taxpayer would have to pay tax on any gain on the property and the CRA won't need to prove any misrepresentation attributable to neglect, carelessness, wilful default or fraud to extend the reassessment period. Alternatively, in the case of a principal residence disposition, the taxpayer will need to make an application for a late principal residence designation, but will be subject to the payment of a late-filing penalty.

It will be more important than ever for individuals to have a proper understanding of the principal residence exemption rules. The rules are particularly complex where more than one property is owned or there has been a change in use of the property. In these situations, individuals should contact a professional tax advisor for assistance. ◆



Technology reinvents the tax function

Extract from EY's "The workplace reinvented"

Technology is reshaping the workplace, and the tax industry is no exception. Get ready to share your workload with computers. Adapt to a changing role, and potentially amplify your own intelligence.

For centuries, tax compliance work has been a handcrafted business that involves a professional manager extracting data from a company's accounts, and then submitting returns to a tax authority in a prescribed manner. Technology, however, is challenging our entire notion of work. It is transforming how we interact with each other, how we allocate our time and resources, and where and when we choose (or are told) to work. No industry is safe. Even the way tax solutions are sought and dispensed is changing, forcing practitioners to adapt at high speed.

The rise of new innovations offers opportunities, as well as threats, for tax professionals. Richard Susskind, the UK- based co-author of The Future of the Professions, and president of the Society for Computers and Law, believes the tax world will benefit from the introduction of software capable of making sense from mayhem or disorder. He points to the US tax code, which becomes more complex — and difficult to understand, even to highly educated professionals — every year.

"Tax codes in America and elsewhere are complex webs of often barely intelligible rules," Susskind says. "Computers are great at picking apart problems created by humans, and making sense of it all."

The tax profession has already been forced to evolve in recent decades amid technological innovation. Individuals used to rely on accountants to help them file their annual income tax return. Internet-based software programs now let people prepare returns on their own.

"Tax software changed how personal tax services are delivered," says Susskind.

"Think of it as a 'community of taxpayers.' If you have a tax-related problem, you can go online and find people willing to help you."

"Bots" at work

Further change is ahead. "Bots" software applications that run repetitive tasks at super-high speeds are moving into the tax sphere. These little packets of hard-working code will transform the way people interact with the tax function, predicts Beerud Sheth, cofounder and CEO of San Francisco-based Gupshup, a chat bot messaging platform for businesses.

Sheth uses the example of white collar workers processing work-related expenses with the aid of an app on their smartphone, while standing in line at a coffee shop or airport. While employees tend to view their expenses as a chore, this will no longer be the case in the future, according to Sheth.

"Imagine all your employees uploading expenses as they go," Sheth says. "You'll be able to see clearly and in real time how money was being spent on what, where and by whom."

Artificial intelligence (AI), the process of machines thinking for themselves, is also expected to change the way professionals work in the tax industry. Experts believe that even intricate tasks will ultimately be done by machines capable of seeking solutions to complex problems. "AI and robotics will be increasingly embedded in every organization," says Tony Steadman, EY Americas Leader for Total Talent Supply Chain. "It will change how we work, how our clients work, and how we serve them."

Adaptation

Investing in the right kind of technology will help professional services firms to better engage with the customer. First, automation, robotics and AI, when working seamlessly and in harmony, could make tax advice better, quicker and cheaper. Second, as technology improves, clients will increasingly demand a more automated form of tax advice. New, intelligent forms of technology will also force companies to reassess how they train employees, from lower-level staff to current and future C-suite executives. In many companies today, workers get to know every aspect of the firm and the industry from their first day on the job, learning how to deal with clients, run teams and manage up and down. Technology is quickly transforming this traditional approach.

"Firms will increasingly assign lower-level tasks, then more higher-level tasks, to machines," Steadman says. "So firms will have to adapt, creating training programs that help young workers learn how to complete more complex tasks, earlier in their careers. It is the only way to stand them in good stead as they evolve into senior staffers."

While some experts and practitioners believe machines will struggle to solve highly technical tax issues for a multinational company or a high-net-worth client, with assets and property spread around the world, Susskind isn't so sure.

"Tax planners still believe their jobs are too complex to be done by a machine," Susskind says. "But wherever we look, however complex the challenge, there is someone creating software that is taking on tasks that we used to think required human experts. Tax work will be no exception. No one is immune."

Smarter humans

Experts believe there is another way that technology could develop in the workplace in which people and machines communicate with one another through a shared language and skill set. It is known as augmented intelligence or intelligence amplification (IA).

These are systems that can enhance human capabilities by connecting the visual cortex — the best-understood part of the brain — with a computer. IA is still in its infancy, but its potential uses are endless.

In the long term, IA could help humans process larger amounts of data and detail over a shorter period of time: vital for helping, say, a call center employee to locate a problem in a customer's account.

IA will also change the finding of tax solutions: an "augmented" human hooked up to a grid could match the right guidance to the right client and situation, far faster. Those most likely to embrace IA will be young professionals on short-term contracts, says Daniel Araya, Hult-Ashridge Research Fellow at the Global Center for Disruptive Innovation in San Francisco.

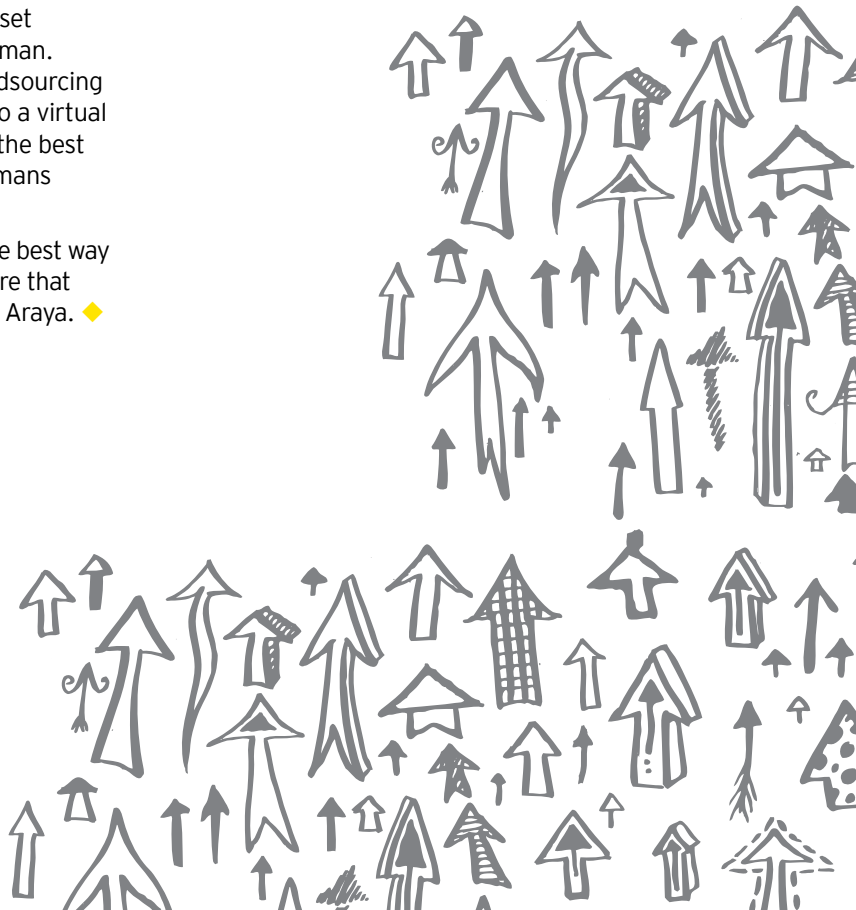
That makes sense, given that the workforce of the future is likely to be scattered around the world, with individuals paid on a piecework basis by companies and institutions.

"Most of your employees will not be sitting at a set location doing the same thing," says EY's Steadman. "Instead, companies will communicate via crowdsourcing or work management tools, handing out tasks to a virtual network of employees." IA will also likely prove the best way to ensure that machines do not replace humans entirely at work in the future.

"Adding capabilities to the biological human is the best way to empower our existing labor force, and to ensure that they perform tasks better than computers," says Araya. ◆

Key action points

- Tax professionals must embrace technological innovation and prepare to adapt the way they provide tax services.
- Tax departments should leverage robotics and artificial intelligence to take on some low-level, form-driven work.
- The tax function should follow developments in IA, which claims to enhance the way humans and machines work together.



Surplus stripping in the context of a corporate reorganization

Poulin v Her Majesty the Queen, 2016 TCC 154
Rachel Robert, Montreal and Brian Studniberg, Toronto

In *Poulin v Her Majesty the Queen*, the Tax Court of Canada (the TCC) found that the fact that taxpayers had organized a transaction in order to enable them to benefit from a capital gains deduction did not necessarily mean that the parties were acting in concert without separate interests.

Section 84.1 of the *Income Tax Act* (the Act) is an important anti-surplus stripping rule designed to stop the extraction of corporate surplus as an exempt capital gain. In order for the provision to apply, several elements are required, including a need for a transfer of a Canadian corporation's shares by a Canadian-resident taxpayer other than a corporation (such as an individual) to another non-arm's-length corporation. Based on guidance offered by previously decided cases, the TCC concluded that the provisions of section 84.1 did not apply to a first 2007 transaction between Mr. Poulin and the corporation Gestion Turgeon, but did apply to a second transaction in 2007 between Mr. Turgeon and the corporation Gestion Hélie.

Facts

Les Constructions de l'Amiante Inc. (Amiante) was a construction company that specialized in building roads, water supply systems and other related works. Mr. Poulin was hired as an Amiante employee in 1981 and Mr. Turgeon joined in 1985. Mr. Poulin was responsible for company administration and Mr. Turgeon worked as a company foreman at its construction sites.

Each of the individuals became shareholders of Amiante. By 2004, Mr. Poulin and Mr. Turgeon each held 50% of Amiante's common shares. Their co-tenure as the company's principals was rocky, however, and following several conflicts between them, each taxpayer contemplated leaving Amiante and to this end devised possible exit scenarios.

In an attempt to resolve the situation, Mr. Poulin and Mr. Turgeon decided to accept Mr. Bilodeau, an Amiante employee, as a new shareholder and, accordingly, reorganized Amiante's share capital in September 2005. Under the reorganization, the taxpayers froze their common shares by converting their value into new preferred shares. (The stated redemption value of each taxpayer's preferred shares matched the capital gains exemption potentially available under the Act.) Then Mr. Poulin, Mr. Turgeon and Mr. Bilodeau each subscribed for 1/3 of Amiante's new common shares.

However, Mr. Bilodeau's arrival as a shareholder did not resolve the conflicts that existed between Mr. Poulin and Mr. Turgeon. In a letter sent in December 2006, Mr. Poulin expressed his desire to gradually leave Amiante. It was this indication of Mr. Poulin's intentions that motivated the planning that led to the 2007 transactions.

In April 2007, the Amiante shareholders agreed to a new plan for the company's structure encompassing Mr. Poulin's departure by March 2010, but agreed to defer its closing until Amiante's financial statements were prepared. Before the statements were prepared, however, a new conflict emerged between Mr. Poulin and Mr. Bilodeau, with the latter quitting the company and demanding that his share interest be repurchased. Thus in September 2007 a new plan was formulated by which Mr. Poulin agreed to defer his departure to 2012.

In light of Mr. Bilodeau's unexpected departure from the company, Mr. Turgeon then approached Mr. Hélie, a key Amiante employee since 2004, to become an Amiante shareholder, with the plan being that Mr. Hélie would eventually be able to take care of the work done by Mr. Poulin.

Following the September 2007 reorganization, Mr. Poulin held 32% of Amiante's common shares, Mr. Turgeon held 57.5%, with Mr. Hélie holding 10.5%. Mr. Poulin sold his preferred shares to Gestion Turgeon (a holding company incorporated by Mr. Turgeon) in return for a promissory note, with payments being made over five years. Mr. Poulin was also required to dispose of all of his remaining shares in Amiante by no later than 31 December 2012.

Mr. Turgeon sold his preferred shares to Gestion Hélie (a holding company incorporated by Mr. Hélie). Mr. Hélie issued a promissory note (with no fixed term for repayment) to Mr. Turgeon to pay for the preferred shares. The agreement between Mr. Turgeon and Mr. Hélie stated that Amiante would pay its shareholders at least 80% of its net profits each year in the form of dividends or by way of share redemptions, adding that 90% of what Mr. Hélie received from Amiante in this way would be paid to Mr. Turgeon as repayments under the note.

Both Mr. Poulin and Mr. Turgeon reported taxable capital gains in 2007 on the dispositions of their Amiante preferred shares, for which they claimed a capital gains deduction.

The minister of national revenue (the Minister) argued that there was a non-arm's-length relationship between each individual taxpayer and the corporation that his preferred shares had been sold to and, as such, that the proceeds of sale for each of the taxpayers constituted deemed dividends (not capital gains) in accordance with paragraph 84.1(1)(b) of the Act.

The Minister observed that the balance of the price paid for the shares in the form of obligation recorded in the promissory note was paid entirely by funds arising from Amiante's buyback of the shares.

Thus the Minister argued that each of the holding companies was acting as a conduit for the money flowing from Amiante and to its shareholders and had been interposed to help the individual taxpayers to claim a capital gains deduction. The fact that the parties were not

acting at arm's length, in the Minister's submission, meant that paragraph 84.1(1)(b) applied to deem a dividend to have been paid to the taxpayer by the holding companies.

TCC decision

The ultimate disposition of this decision rested on the factual determination as to whether the parties in this case had a non-arm's-length relationship (on the one hand between Mr. Poulin and Gestion Turgeon and on the other hand between Mr. Turgeon and Gestion Hélie). To support its analysis, however, the TCC reviewed a number of principles that had been established in prior cases.

At the outset, the TCC stated that, as confirmed by the Department of Finance's explanatory notes to the Act and by the TCC itself in earlier cases (Descarries v The Queen, 2014 TCC 75, and Desmarais v The Queen, 2006 TCC 44), section 84.1 of the Act is an anti-avoidance rule designed to prevent taxpayers from performing transactions where the goal is to remove taxable corporate surplus as a tax-free return of capital through a non-arm's-length transfer of shares by an individual resident in Canada to a corporation for the use of a capital gain exemption or a tax-exempt margin.

In light of the relevant authorities, the TCC also reflected on a number of principles:

- Parties acting in concert without separate interests indicates that the parties were not dealing at arm's length as part of a transaction.
- To determine if parties were acting in concert without separate interests, one must examine if they were acting for their own benefit.
- All of the relevant facts should be examined in order to evaluate whether the parties were dealing at arm's length.
- The interests of each party to an agreement must be analyzed to determine whether each party acted in concert.
- The buyer and seller do not act in concert simply because their agreement could be expected to benefit both of them.

In the present case, the TCC noted that there were several important facts that prompted the parties to transact as they did. The TCC found that it was in the interests of Amiante that either Mr. Poulin or Mr. Turgeon leave the corporation. All of the evidence demonstrated that Mr. Poulin had intended to leave, but also that his departure was delayed due to unforeseen circumstances in the form of Mr. Bilodeau's abrupt departure.

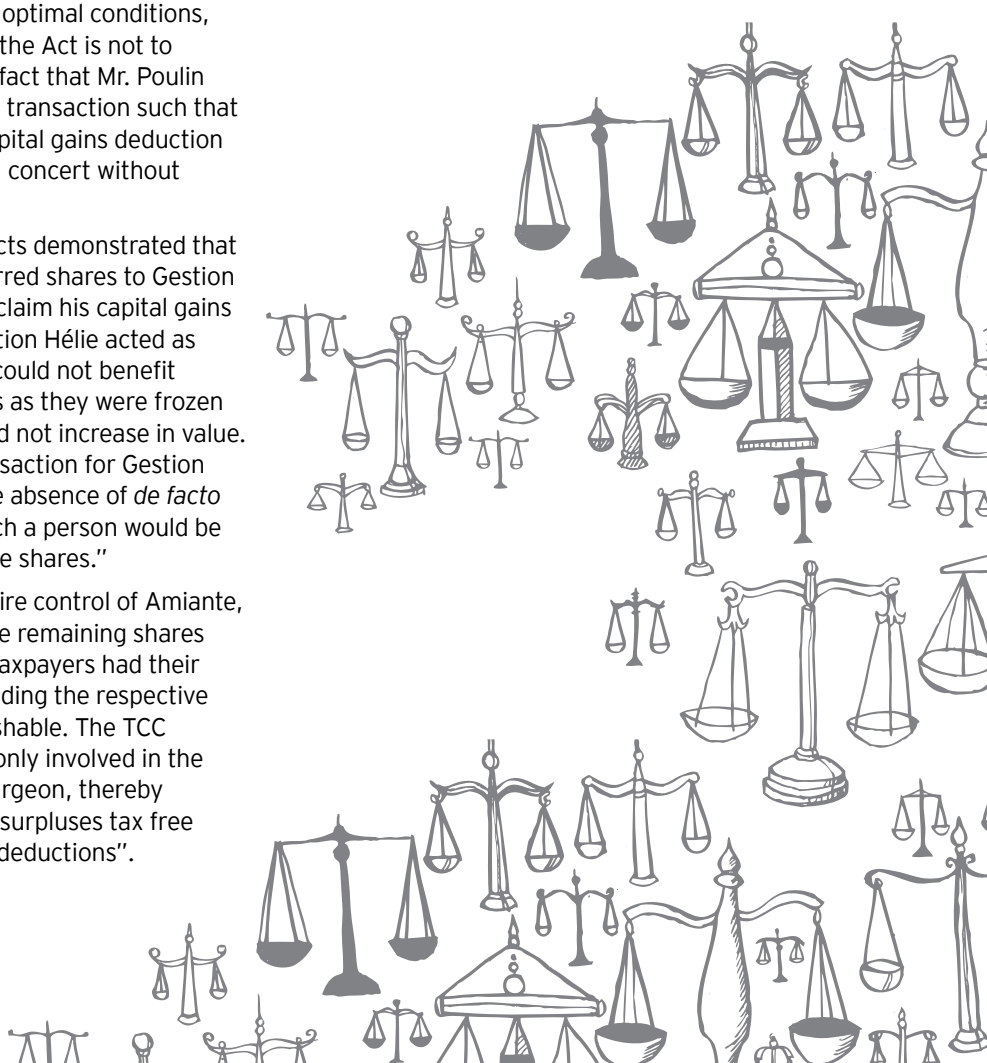
In the TCC's view, Mr. Poulin had the right to sell his interest in Amiante under the most optimal conditions, and the purpose of section 84.1 of the Act is not to prevent this kind of situation: "The fact that Mr. Poulin and Mr. Turgeon had structured the transaction such that Mr. Poulin could benefit from his capital gains deduction does not mean that parties acted in concert without separate interests."

However, as for Mr. Turgeon, the facts demonstrated that the purpose of the sale of his preferred shares to Gestion Hélie was to enable Mr. Turgeon to claim his capital gains deduction. The TCC found that Gestion Hélie acted as an accommodation party in that it could not benefit from buying these particular shares as they were frozen preferred shares and, as such, could not increase in value. There were also no risks to the transaction for Gestion Hélie. The TCC ventured that, in the absence of *de facto* control, "few scenarios exist in which a person would be interested in obtaining similar freeze shares."

Mr. Turgeon's objective was to acquire control of Amiante, which he did when he purchased the remaining shares held by Mr. Poulin. Both individual taxpayers had their own interests and the facts surrounding the respective sales of their shares were distinguishable. The TCC concluded that "Gestion Hélie was only involved in the transaction for the benefit of Mr. Turgeon, thereby allowing him to strip Amiante of its surpluses tax free through the use of its capital gains deductions".

Lessons learned

The TCC's decision in *Poulin* reiterates the general point that taxpayers are permitted to reorganize their business affairs in order to benefit from potentially available tax relief, but when doing so they must ensure that the method used is permitted, and this evaluation must be made with a careful eye to the taxpayer's particular situation. More specifically, in terms of "employee buyco" planning, it remains to be seen whether this decision will embolden the tax authorities in respect of their use of section 84.1 when employer-controlled corporations are used to purchase shares held by departing employees. ◆



Publications and articles

Tax Alerts – Canada

Proposed legislative amendments may tax cross-border notional cash pooling arrangements – 2016 Issue No. 44

On 29 July 2016, the Department of Finance released for public comment a package of draft legislative proposals and explanatory notes relating to a number of measures that were previously announced in the 2016 federal budget. Among other measures, the package would expand the back-to-back loan rules, which may impact a broad range of cross-border cash pooling arrangements. While the tax effectiveness of cross-border cash pooling has already been reduced in past years, the proposed measures, if implemented, may further restrict the use of cash pooling arrangements.

Proposed amendments to principal residence exemption rules for trusts and nonresidents– 2016 Issue No. 45

On 3 October 2016, federal Finance Minister Bill Morneau announced new measures relating to the capital gains tax exemption on the disposition of property that may be designated as a principal residence. The amendments revise the calculation of the principal residence exemption for individuals who are nonresidents of Canada throughout the year of acquisition of the property as well as certain trusts that will no longer qualify to designate a property as a principal residence after 2016. Additional amendments include an extended assessment period for taxpayers who do not report the disposition of the property on their tax return.

Individuals who purchase property in Canada while nonresident of Canada and beneficiaries of certain trusts should review the new rules and the tax implications of disposing of property that may no longer qualify for the principal residence exemption after 2016.

Finance tables NWMM for 2016 budget measures and various technical changes – 2016 Issue No. 46

On 21 October 2016, federal Finance Minister Bill Morneau tabled a notice of ways and means motion that includes the draft legislative proposals that were released on 29 July 2016 relating to the remaining outstanding measures announced in the 2016 federal budget, as well as certain previously announced measures from the 2015 federal budget.

Publications and articles

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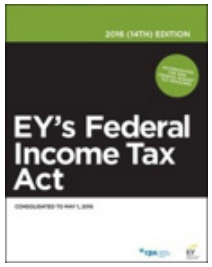

EY's Federal Income Tax Act, 2016 (14th) Edition

Editors: Alycia Calvert, Fraser Gall, Angelo Nikolakakis

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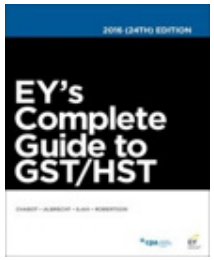

EY's Complete Guide to GST/HST, 2016 (24th) Edition

Editors:Jean-Hugues Chabot, Dalton Albrecht, Sania Ilahi, David Douglas Robertson

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