Section 84.1: What brought Poulin and Turgeon to the table?

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August 19, 2016

Section 84.1 of the *Income Tax Act* (*Act*), in its current form, was introduced in 1985 (concurrent with the introduction of the capital gains deduction), and the provision has always been a source of heartburn for planners. It is a very broad anti-avoidance rule that tries to prevent surplus from being stripped from corporations as a tax-free capital distribution, rather than a taxable distribution in the form of dividends. In order for section 84.1 to apply, there needs to be a transfer of shares of a corporation by an individual or trust to another corporation with which the individual does not deal at arm's length, and immediately after the disposition, the purchaser corporation and the corporation whose shares are being transferred are connected. While the *Act* deems related persons to not deal at arm's length, it also states that it is a question of fact whether persons who are not related to each other are, at a particular time, dealing with each other at arm's length. If section 84.1 applies, then the otherwise tax-free return of surplus in the form of capital distributions will be turned into a taxable distribution in the form of dividends.

The analysis as to whether or not section 84.1 applies to a particular share transfer by an individual to a corporation often comes down to the elusive determination of factual arm's length. On June 14, 2016, the Tax Court of Canada released its decision in the cases of *Poulin v Queen* and *Turgeon v Queen* heard on common evidence[1]. These cases involve two unrelated shareholders, both of whom attempted to extract corporate surplus as a capital gain to which they could claim the capital gains deduction. One of such shareholders was exiting the company, the other remained active. This decision is particularly useful in that it compares two slightly different scenarios, and decides that section 84.1 applies to one of the scenarios but not the other. We will review the judgment and extrapolate it to provide useful takeaways for practitioners.

Poulin and Turgeon, two unrelated Canadian individuals, were principal shareholders of Amiante, a Canadian corporation. Over a number of years, several conflicts arose between Poulin and Turgeon to the point where both parties contemplated parting ways and selling their respective interests in Amiante to the other. Ultimately, Poulin expressed his desire to gradually leave Amiante, and Hélie, an employee of Amiante, would become a new shareholder to replace Poulin's role within the company.

Poulin and Turgeon reached an agreement in 2007 whereby Poulin would sell all his interest in, and depart from, Amiante by 2012. As part of this, Poulin was to sell a portion of his shares to Turgeon and his holding company, Gestion Turgeon (GT), in 2007. Amongst other transfers in 2007 that resulted in Turgeon taking over control of Amiante, Poulin sold $450,004 of Amiante Class F preferred shares to GT. At the same time, Turgeon sold $388,861 of Amiante Class D preferred shares to Hélie's holding company, Gestion Hélie (GH). Both the Class F and D preferred shares were fixed value and non-voting. Both Poulin and Turgeon reported capital gains on the disposition of these preferred shares in 2007, and both claimed the capital gains deduction to fully offset such realized gains.

Poulin's sale of Amiante Class F preferred shares to GT was under the following terms:

- A cash payment of $45,000 within one month;

- The balance of $405,004 bore interest at 5%, and was payable through five annual payments, equal to the higher of $81,001 or 90% of amounts received by GT from Amiante;

Whereas, Turgeon sold his Amiante Class D preferred shares to GH under the following terms:

- No upfront payment and the entire balance of $388,861 bore interest at 4%;
- No fixed term or amount of repayment with the agreement simply stating that GH will use 90% of sums received from Amiante to pay the amount owing to Turgeon.

Also, as part of the arrangement, Amiante agreed to pay its shareholders (which included GT and GH) at least 80% of its annual net profits, in the form of dividends or otherwise. Indeed, from 2008 to 2010, Amiante bought back all of the Class F preferred shares held by GT for cash, and GT fully paid off Poulin before the end of 2010. In contrast, Amiante bought back only a portion of the Amiante Class D preferred shares held by GH between 2008 and 2012 and paid only a portion of what it owed Turgeon. No dividends were ever paid on Class F and D Amiante preferred shares while they were held by GT and GH.

The Canada Revenue Agency (CRA) reassessed Poulin and Turgeon by applying section 84.1 to deem them to have received taxable dividends, rather than capital gains (and offsetting capital gains deductions) on their disposition of preferred shares in 2007. (A reminder: this reassessment – if correct – would turn an otherwise tax-free transaction into a taxable one since taxable dividends cannot be offset by the capital gains deduction). In the CRA's view, both dispositions were non-arm's length transfers and all of the other conditions in section 84.1 were met as well. Specifically, the CRA asserted that GT and GH were simply acting as conduit helping Poulin and Turgeon claim their capital gains deduction, and they themselves had no interest in buying preferred shares whose value were frozen while paying interest on the purchase price.

The Court undertook an analysis of the jurisprudence on non-arm's length relationships, which primarily looks at 1) was a common mind directing the bargaining for both parties? 2) were the parties to a transaction acting in concert without separate interests, and 3) was there "*de facto*" control of one party over another[2].

In the analysis, the Court focused on the second criteria: whether the parties were acting in concert without separate interests. Citing a number of precedent cases[3], the Court found the following to be indicators of parties not acting with their own separate interests:

- The terms of the transaction not reflecting ordinary commercial dealings between a vendor and a purchaser acting in their own interests;
- A person not acting for his own benefit or, even if he is, he is also acting for someone else in a context of reciprocity (however, buyer and seller do not act in concert simply because the agreement which they seek to achieve can be expected to benefit both);
- Whether the parties' conduct after the transaction reveals that the party who helped the other party clearly had no independent role.

With these in mind, the Court analyzed Poulin's and Turgeon's dispositions separately. With respect to Poulin, the Court noted that the major conflict between Poulin and Turgeon, and the arduous negotiations involved. The Court did not find the fact that Poulin and Turgeon structured the transaction to allow Poulin to claim the capital gains deduction to necessarily mean the parties acted in concert without separate interests. Each party was guided by his own objectives: Poulin wanted to sell his Amiante interest tax efficiently, and Turgeon wanted to acquire control of Amiante. Consequently, the

Court found that Poulin and GT dealt at arm's length and section 84.1 did not apply.

In contrast, the Court noted there had never been any conflicts between Turgeon and Hélie. More importantly, Hélie and GH bore no risk and obtained no benefit in respect of the transaction. No dividends were declared on the Amiante Class D preferred shares while they were held by GH, and, at any time, GH could force Amiante to buy back all the Class D preferred shares so it could fully repay Turgeon. Also, unlike the amount owing between Poulin and GT, there was no stipulated repayment period for the amount owing between Turgeon and GH – with the Court specifically noting that a balance still remained payable at the hearing date of the case. Moreover, in 2014, GH transferred the remaining Amiante Class D preferred shares to another corporation of which Turgeon was President. The Court also contrasted the fact that Poulin left Amiante for good as planned in 2012, while Turgeon continued to work at Amiante as the majority shareholder and a director. In these circumstances, the Court viewed GH as having no interest in the transaction besides enabling Turgeon to claim his capital gains deduction, and no role independent of Turgeon. Accordingly, the Court upheld the CRA's reassessment of section 84.1 in respect of Turgeon.

The value of these sister cases is that their dichotomy helps identify relevant factors for determining when parties are acting in concert without separate interests in respect of 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 vs. the Turgeon-GH sale were:

1. The payout term of the debt issued on purchasing the preferred shares (fixed in the case of Poulin-GT sale vs. open-ended in the case of Turgeon-GH sale); and
2. Whether the vendor remained involved with the subject corporation (Poulin's departure in the case of the Poulin-GT sale vs. Turgeon remaining as the controlling party in the case of the Turgeon-GH sale).

We find it helpful to distinguish the role these factors played using the expression "coming to the table", within the context of meaning willing to negotiate (the negotiations themselves, therefore "happening at the table"). 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 an exit from the company, extracting the most value from his shares as possible along the way (thus, the fixed payout term of the debt). Turgeon/GT was interested in the increased control and larger participating equity in Amiante that would result from Poulin's exit (i.e. although the transaction analyzed was a purchase of preferred shares, this purchase formed part of a larger arrangement where Poulin exited the company as a common shareholder and employee). This is what brought each party to the table, which was differing interests, and therefore an arm's length relationship existed. It did not sway the Court that once 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 is in contrast. GH's reason for being at the table was accommodation. Its sole purpose of entering the transaction was to allow Turgeon to use the capital gains deduction in extracting corporate funds (as partly evidenced by the open-ended payout terms of the debt). This was clearly Turgeon's reason for coming to the table too.

Although we hope this illuminates the rule of law in Poulin and Turgeon type situations, rarely does one encounter a client situation identical to a case. The degree of certainty a case provides is, therefore, commensurate with the similarities and difference to the reality faced. So, when implementing any share transfer arrangement where factual arm's length is determinative of whether section 84.1 would apply, it is important to ask: "Is this more like a Poulin or a Turgeon scenario? How similar is it? Are there changes to the proposed structure which will make it more Poulin-like and/or less Turgeon-like?" And ultimately, "What is the risk-benefit mix at play? Is it worth it?"

For example, an interesting hypothetical is to consider a Turgeon-GH type of purchase, however, the purchasing party is compensated for its accommodation via dividends on the shares it purchases (prior to their repurchase by the subject corporation). On the one hand, the purchasing party is now at the table to make a profit; this is its own separate commercial interest which has an impact on the arrangement/structure used. On the other hand, maybe this is a different 'table'. The purchasing party negotiated at arm's length to be an accommodating party, but once that was agreed to, its role in respect of the purchase potentially subject to section 84.1 was as an accommodating non-arm's length party. Perhaps this is the "reciprocity" referred to by the court earlier in the article. The joint authors have differing opinions on this, so that is a grudge match for a different day.

It will also be interesting to see what implication this case has to in "Employee Buyco" situations. Employee Buycos are employer controlled corporations created to purchase shares of the employer corporation held by departing employees, allowing those employees to obtain capital gains treatment (rather than a deemed dividend on a share redemption or cancellation).

It is within this context that the CRA, at the 2012 Canadian Tax Foundation National Conference, announced a change in its administrative position on Employee Buyco transactions. Previously, the CRA allowed Canadian-controlled private corporations (CCPCs) employers to create such Employee Buycos to purchase shares of the CCPC held by the departing employees, facilitating capital gains treatment (as mentioned above) and potentially use of the capital gains deduction by the employees. At the conference, the CRA announced that it may start to apply section 84.1 to such arrangements due to the degree of accommodation between the parties. This caused quite a bit of uncertainty to taxpayers with Employee Buyco structures. Perhaps lessons learned from this decision can assist with the design of such structures to reduce the likelihood of section 84.1 applying?

Overall, the case of Poulin and Turgeon provides useful guidance and should be considered in any similar type of transactions where section 84.1 could be an issue. Will the heartburn experienced by planners with respect to section 84.1 be eliminated or reduced as a result of this case? No. But perhaps planners will now be in a better spot to identify heartburn risks as a result of the illustrations of Poulin and Turgeon.

[1] 2016 TCC 154.

[2] These criteria are listed in now archived CRA Interpretation Bulletin IT-419R2 (replaced by Income Tax Folio S1-F5-C1, Related Persons and Dealing at Arm's Length), and they were cited with approval by the Supreme Court of Canada in *Canada v McLarty,* 2008 SCC 26.

[3] *Petro-Canada v Canada*, 2004 FCA 158; *Gestion Yvan Drouin v Queen*, 2001 D.T.C. 72; *RMM Canadian Enterprises Inc. v Canada*, 1997 T.C.J. No. 302.; *McNichol v Queen*, 1997 T.C.J. No. 5.