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PRINCIPAL ISSUES: Whether subsection 84.1(2.1) will apply to deem a taxpayer to have taken a capital gains exemption in the event a taxpayer claims a subparagraph 40(1)(a)(iii) reserve on the disposition of shares to which section 84.1 applies, even when the taxpayer does not and will not claim any capital gains exemption in respect of the disposition.

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Please note that the following document, although believed to be correct at the time of issue, may not represent the current position of the CRA. Prenez note que ce document, bien qu'exact au moment émis, peut ne pas représenter la position actuelle de l'ARC.

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POSITION: Yes.

REASONS: See below.

XXXXXXXXXX

2015-059446

T. Ng

(416) 512-4013

April 28, 2016

Dear XXXXXXXXXX,

Re: Request for Technical Interpretation – Subsection 84.1(2.1)

We are writing in reply to your letter, in which you requested our comments on the interpretation of subsection 84.1(2.1).

You have indicated in your letter that you wish to have our comments on whether the phrase "the amount in respect of which a deduction under section 110.6 was claimed in respect of the transferor's gain from the disposition shall be deemed to be" will deem a transferor to have claimed a capital gains exemption where a capital gains reserve is taken in respect of the disposition of shares to which section 84.1 applies, even where the transferor does not claim or intend to claim in the future any capital gains exemption in respect of the disposition.

Your position:

It is your view that the use and the placement of the words "was claimed" in the provision do not deem the transferor to have claimed a capital gains exemption. Instead, the deeming provision comes into effect only if a capital gains exemption is actually claimed, in which case the amount claimed will be determined by subsection 84.1(2.1). It is your position that interpreting the provision in this manner is consistent with the drafting of the legislation and the taxation principles relating to a non-arm's length transfer of shares.

Our comments:

This technical interpretation provides general comments about the provisions of the Income Tax Act (the "Act") and related legislation (where referenced). It does not confirm the income tax treatment of a particular situation involving a specific taxpayer but is intended to assist you in making that determination. The income tax treatment of particular transactions proposed by a specific taxpayer will only be confirmed by this Directorate in the context of an advance income tax ruling request submitted in the manner set out in Information Circular IC 70-6R7, Advance Income Tax Rulings and Technical Interpretations.

In general terms, section 84.1 is an anti-avoidance rule designed to prevent the removal of taxable corporation surpluses as a tax-free return of capital through a non-arm's length transfer of shares of one corporation (the "subject corporation") by an individual resident in Canada to another corporation (the "purchaser corporation"). For a detailed description of the conditions of the application of section 84.1, please refer to paragraph 1 of Interpretation Bulletin IT-489R – Non-Arm's Length Sale of Shares to a Corporation, dated February 28, 1994 ("IT-489R").

Section 84.1 achieves its purpose by:

* reducing the paid-up capital of the shares of the purchaser corporation received by the individual in consideration for shares of the subject corporation (this reduction reduces the ability to return paid-up capital of the purchaser corporation, which is basically the legal stated capital of the shares adjusted for tax purposes, as the excess would be taxed as a dividend), and

* deeming the individual shareholder to have received a dividend where the purchaser corporation gives non-share consideration for the shares of the subject corporation (for example, cash or a promissory note).

In essence, section 84.1 allows an individual resident in Canada to recover, in a non-arm's length transfer of shares to a corporation, an amount equal to the greater of the paid-up capital and the adjusted cost base of the shares transferred. Paragraphs 84.1(2)(a) and 84.1(2)(a.1) provide rules for determining the adjusted cost base of shares held by a taxpayer for the purposes of section 84.1.

Paragraph 84.1(2)(a.1) was implemented in 1985 so that the benefit of the capital gains deduction on a gain realized on the disposition of a share would not also result in the additional benefit to the taxpayer or a person not dealing at arm's length with the taxpayer to receive a distribution from the corporation tax-free.

At the time the Act was modified to allow capital gains reserves claimed under subparagraph 40(1)(a)(iii) to qualify for the capital gains exemption under section 110.6, there was no corresponding amendment to section 84.1. As a result, it was possible to circumvent the paragraph 84.1(2)(a.1) reduction in adjusted cost base for the purposes of section 84.1 by having the non-arm's length transferor of the shares claim a capital gains reserve in respect of the transfer and subsequently claim a capital gains exemption when the amount is brought back into income. Subsection 84.1(2.1) was introduced to address this unintended result. It provides a special rule for the purposes of subparagraph 84.1(2)(a.1)(ii) and applies where the transferor or an individual who does not deal at arm's length with the transferor disposes of a share in a taxation year and claims a capital gains reserve under subparagraph 40(1)(a)(iii) on that disposition. This provision essentially treats the transferor as having claimed, to the extent that the transferor has unused capital gains exemption room in the year in which the disposition took place, a capital gains deduction on the disposition, irrespective of whether such exemption was actually claimed, because the reserve could potentially be eligible for a capital gains exemption when brought into income in the future. Whether the transferor intends to claim a capital gains exemption on the reserve in the future is not relevant. We understand that the effect of this rule is to treat a capital gain on a property to be sheltered by the capital gains exemption when there is unused capital gains exemption room in the year of the disposition regardless of whether such capital gains exemption room has been saved to cover a capital gain that could be realized on a disposition of other properties in a subsequent year.

The Canada Revenue Agency is responsible for administering the tax system and applying current legislation, whereas the Department of Finance is responsible for developing tax policy and legislation. If you are in disagreement with the application of subsection 84.1(2.1) and are of the view that a change in legislation is required, we suggest that you contact the Department of Finance.

We trust that these comments will be of assistance.

Yours truly,

Stéphane Prud'homme

Director

Corporate Reorganizations Section II

Income Tax Rulings Directorate

Legislative Policy and Regulatory Affairs Branch

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