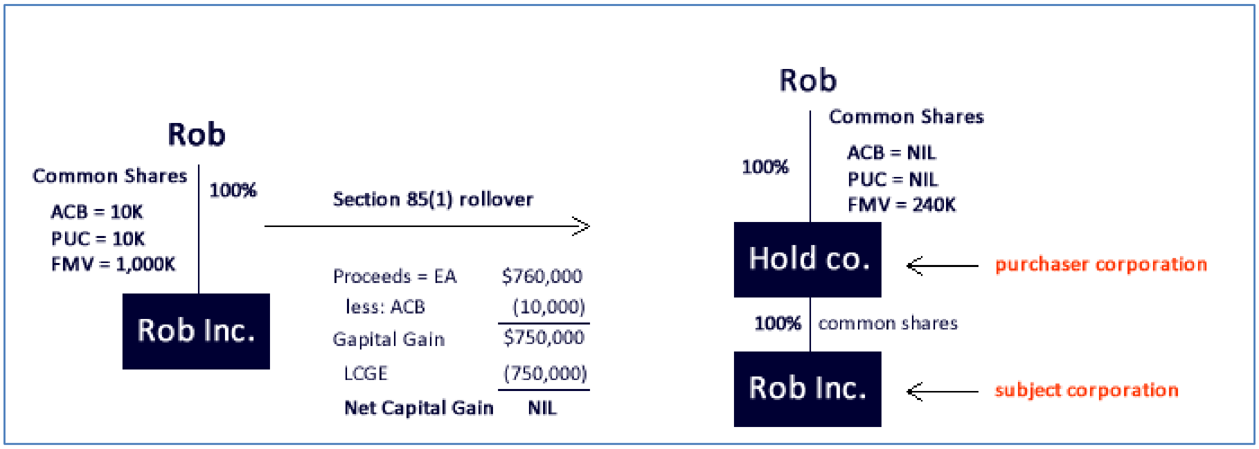
DIVIDEND STRIPPING – SECTION 84.1

What is Dividend Stripping

- In the past taxpayers worked around the tax laws to strip money out of a company tax free by turning dividends into capital gains and using the 750K lifetime capital gains exemption
- To stop these taxpayers from abusing the system, Section 84.1 came into effect to revert capital gains into dividends

How did taxpayers strip dividends out of the company tax free?

Consider the following example:



- Rob, a Canadian Resident, owns all the shares of Rob Inc.
    - ACB = $10,000; PUC=$10,000; FMV= $1,000,000
- Rob then incorporated Hold co. Rob **uses the section 85(1)** to transfer the his shares in Rob Inc. to Hold co.
- Rob Inc. is a QSBC and Rob has the full $750,000 lifetime capital gains exemption unused.
    - Rob elects to transfer his shares @ $10,000+750,000 = $760,000
    - He takes back cash (i.e. boot) of $760,000
    - He takes the remaining value in shares $240,000 (1,000,000-760,000)
- In essence Rob pulled out $760,000 tax free, yet he still “indirectly controls” Rob Inc. through the Holdco.
- Is this fair?
    - No, because when someone has control of a corporation and pulls out money, we call this dividends
    - Rob turned dividends into capital gains, and paid no tax on the capital gains b/c of the QSBC deduction. Thereby, he pulled out dividends tax free.
    - **CRA in essence, will use 84.1 to convert the capital gains into deemed dividends**

Section 84.1

Section 84.1 Applies when **all** the following are met:

1. A Canadian resident taxpayer (other than a corporation) disposes shares of a resident Canadian corporation (called the "subject corporation")
2. The shares are **disposed to a non-arm's length (i.e. related) corporation**
3. The corporation purchasing the shares be **connected with the subject corporation** after the shares are disposed (i.e. connected = own more than 10% of the voting shares)
4. The taxpayer held these shares as **capital property** (see capital gains vs. business income notes)

Does 84.1 apply to our example with Rob?

1. Met – Rob and Rob Inc. are both Canadian residents
2. Met – Rob and Holdco are related since Rob controls Hold co
3. Met - Rob Inc. and Hold co. are connected since Holdco owns more than 10% of the shares of Rob Inc.
4. Met – Rob was not in the business of trading shares

Therefore Section 84.1 applies to Rob's situation

Implications of Section 84.1

1. CRA will treat this like a redemption of shares, and as a result there will be deemed dividends (see redemption of shares notes)
2. The non-share considerations = proceeds of redemption of shares

Deemed Dividends:

Proceeds of redemption	$760,000
less: Paid Up Capital (PUC)	(10,000)
Deemed Dividends	**$750,000**

Capital Gains:

Proceeds of disposition	$760,000
Less: deemed dividends	(750,000)
Adjusted Proceeds	**$10,000**
Less: Adjusted Cost Base (ACB)	10,000
Capital Gains	**$NIL**

How to do a legitimate estate freeze while not falling into the 84.1 Pitfall?

- In an estate freeze, a father may transfer shares to a hold co. controlled by his son while still taking advantage of the 750K QSBC deduction
- Section 84.1 will apply in that instance since the father and the hold co. are considered related
- The goal is to avoid any deemed dividends since dividends are not subject to the QSBC deduction
- **To avoid the deemed dividends,**
    - the father should take back **maximum non-share consideration** (i.e. boot) equal to the **higher of:**
        a) Paid up Capital (PUC); and
        b) Adjusted Cost Base (ACB)
    - Anything higher will trigger deemed dividends!
    - To make in simple, it is common to take back no boot