CCH Estate Planner

Federal Budget “Targets” Planning Involving Minors

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The capital gains exemption for shares of a “small business corporation” has become something of a sacred cow. What was once thought to be a temporary incentive has now endured for a quarter of a century. However, Budget Resolution 23 (“BR #23”)**[1]** – as well as a recent CRA French-language edict**[2]** - both appear to indicate that the multiplication of the exemption amongst family members is attracting government ire.

When the exemption came into effect, early manoeuvres were designed to preserve the benefit of the exemption - lest the government suddenly pull the plug on it - often through so-called “crystallization” manoeuvres. However, as the exemption became entrenched the tax landscape, the focus gradually shifted to manoeuvres designed to preserve and multiply the exemption among family members.

These plans would commonly take advantage of the exception in the corporate attribution rules that otherwise discourage freezing for the benefit of minor children and spouses provided that the shares of the frozen corporation are shares of a “small business corporation”. In addition, when such planning was put in place for minors it appeared to be relatively “plain vanilla”**[3]** from a risk perspective since sections 74.2 (capital gain splitting attribution rules) and 120.4 (the “kiddie tax” rules) of the Income Tax Act (“Act”)(Canada)**[4]** were drafted so that they would not apply in respect of ordinary or exempt capital gains realized by minors, whether or not a freeze was involved.**[5]**

As such planning pertains to minors, it appears to now be specifically under fire in BR #23. More precisely, BR #23 proposes measures to extend the kiddie tax to capital gains realized, or included in the income of a minor**[6]** from the disposition of shares of a corporation to a person who does not deal at arm’s length with a minor, if taxable dividends on the shares would have been subject to the kiddie tax – as would be the case for shares of private companies. Would-be capital gains that are subject to this proposal will be treated as dividends subject to the kiddie tax and will therefore not benefit from the capital gains inclusion rates nor qualify for the capital gains exemption. The measure applies to capital gains realized on or after March 22nd, 2011 (more on this later).

The Budget papers themselves indicate that the foregoing is a “targeted measure to maintain the integrity of the tax on split income” – i.e., to catch income-splitting techniques that have been developed to split capital gains with minors thereby avoiding the kiddie tax.

Under Attack: Claims by Minors:

When I saw the word “targeted” in BR #23, my first reaction was to presume that BR #23 was aimed at well-known “strip” transactions in which would-be dividend treatment is “transmogrified” into capital gains taxation**[7]** – manoeuvres that are the subject of a number of pending GAAR cases.

However, a closer look at BR #23 revealed that the “target” was a lot bigger - more along the lines of a general attack on capital gains splitting with children and other minors. Having said this, tax vets know that a literal reading of a budget resolution can be dangerous – and that the Department of Finance can change the wording, especially since the federal election has put the Budget in limbo.**[8]** As will become clear from the discussion below, just because BR #23 may one day be clarified will be cold comfort for taxpayers (and their advisors) caught in its far reaching grasp.

A literal reading of BR #23 appears to put into jeopardy nearly all transactions where capital gains in respect of non-public company shareholdings would be claimed by a minor – whether or not the exemption applies.**[9]** For example, if a trust owns shares in an Opco and one wants to crystallize the exemption of the beneficiaries who are minors, this proposal would generally catch such a transaction and replace the crystallization with a deemed dividend.

Similarly, if a trust owns shares of a private corporation, e.g., operated by a parent, and parent buys the trust's shares in order to enable minors to use their exemptions and to stop future growth from accruing to the trust, this transaction seems to be caught by the proposal.

Next, consider the impact of the BR #23 on a standard estate freeze. Although by convention a freeze works because the "freezor" is considered to have capped the value of the freezor's shares and, a trust or other beneficiary is allowed to acquire shares of the frozen corporation for a nominal amount of subscription proceeds, even if the trust and the corporation are unrelated, such an acquisition would be unlikely to be viewed as having taken place on an arm's length basis.

Suppose that, some years later, the common shares held by the family trust are sold to a third party. BR #23 itself indicates that if a minor would otherwise be required to include in computing income a capital gain from the disposition of the shares of a corporation that is part of a transaction or event, or series of transactions or events, that includes the acquisition of shares by a person who does not deal at arm's length with the minor (i.e., the original acquisition of shares by the trust from the operating corporation), the capital gain, exempt and non-exempt, will be transmogrified (there's that word again) into a dividend to which the kiddie tax will apply.

Of course, whether or not the subsequent sale is part of the same series of transactions as the original freeze is debatable and largely fact dependent.**[10]** The Supreme Court of Canada's judgment in the Copthorne Holdings**[11]** appeal will hopefully shed light on this issue; however, the decision has not yet been released by the Court.

Arguably a trust that acquires shares of a start-up in the absence of a freeze may also be caught by this provision if it could be argued that the entrepreneur would never have given away her equity stake to a party that does not bring value to the table (i.e., the trust) and an offending series is considered to exist.

But it gets worse. A beneficiary and a trust are deemed to deal with one another on a non-arm's length basis pursuant to paragraph 251(1)(b). As a result, even if the acquisition of shares by a trust would otherwise be considered to have occurred on an arm's length basis, the actual wording of BR #23 will catch every acquisition of private company shares by a trust with a minor beneficiary (i.e., by definition the acquisition by the trust will not be made at arm's length with the minor) if the sale of the shares is considered to be part of the series involving the acquisition of the shares.

As stated previously, this measure applies to capital gains realized on or after Budget day. If the sale takes place on or after March 22nd, and is part of the same series of transactions as any acquisition of the shares by a person non at arm's length with the minor child, the sale would appear to be caught by the Budget Resolution, even if the acquisition by or on behalf of the minor took place years ago.

Based on informal discussions my I have had with the Department of Finance, we understand that Finance was aware BR #23 would curtail crystallization transactions, which they did not consider problematic.**[12]** However, the individuals we spoke did not seem to appreciate the scope of potential effects of BR #23 that we have just described.

Arguably some more seasoned transactions involving non-arm's length acquisitions should be less likely to be considered to be part of the same series of transactions as the post-Budget sale. Trouble is, based on the current state of the law, especially when BR #23 is combined with the CRA's views in APFF question 34 (see below) and Copthorne, it creates uncertainty in nearly every transaction involving a sale of shares of a private corporation involving minor shareholders. In other words, due to the uncertainty as to the tax results in what I previously would have thought would

have been considered to be a well accepted and commonly implemented private company tax planning technique, practitioners will be well advised to warn their clients of the risks of splitting capital gains with minors.

In this respect, I should emphasize that, if the proposal does apply, there is a downside vis-à-vis capital gains status. Apart from the possibility of losing the capital gains exemption, the effect of the resolution is to impose tax on the basis of a non-eligible dividend. In Ontario, this would attract a tax rate of 32.57%, as opposed to the 23.2% rate that applies to a capital gain or 0% if the gain had been eligible for capital gains exemption treatment.**[13]**

APFF Round Table Question 34

Whether the ambit of the budget resolution itself will ultimately be restricted in the actual legislation remains to be seen. However, another recent development may be indicative of the government's increasingly frosty attitude to capital gains splitting.

In Question 34 of the 2010 APFF Round Table, the CRA was asked to comment on situations in which family trusts are misused and could attract the General Anti-Avoidance Rule. Not surprisingly, the CRA identified sequestering capital gains offshore and inter-provincial tax planning as abusive.**[14]** However, depending on the translation (the question is entirely in French and no official translation has been provided), the CRA's answer may well be interpreted to indicate that the multiplication of the capital gains deduction could be abusive. In particular, based on the informal interpretation we received it appears that where in the context of a disposition of a taxpayer's shares, a structure comprising family trusts and accommodating parties is put in place with the goal of avoiding tax on capital gains the CRA will view the structure as being abusive.

In this regard, the CRA's response is very generally worded; it gives no guidance as to whether there are situations in which any degree of capital gains multiplication in a family trust would be acceptable (the CRA did not specifically refer to minors claiming the exemption). The CRA indicated that GAAR would be problematic if the structure is put in place to avoid tax on capital gains by the splitting of the gain and claiming the exemption and that is all.

If capital-gains-exemption multiplication is now on the list of trust tax planning "schemes" that the CRA finds offensive, query would the CRA consider applying the sham doctrine to such schemes? I am told that, in the months since the Federal Court of Appeal decision in Antle**[15]** was released, the CRA has become very fond of it.

Trends?

If the APFF comments are not "lost in translation", one may query whether BR #23 and the APFF comments are part of a growing and in my view a concerning trend.

Ignoring the APFF comments for the moment, and assuming Finance is taken at face value that BR #23 was intended to have been a "targeted measure", it is possible to have sympathy for the motivation leading to the introduction of BR #23.

A more cynical view could see BR #23 and the APFF comments as part of the on-going attack on wealthy taxpayers**[16]** or as the thin edge of the wedge in the beginning of an attack on capital gains exemption planning generally.

In this regard, one might be concerned that Finance and the CRA see this type of planning as the domain of the rich. In fact, arguably it is one of the few tax planning opportunities that is available to Canada's entrepreneurial class – rich or just one day hoping to be rich.

Assuming the foregoing are not the intended consequences, then until Finance is able to more precisely "target" and/or define its objectives, I do not see any way to eliminate the uncertainty caused by its introduction short of BR #23 being cancelled in entirety. Similarly, we would hope that

the CRA would take steps to more narrowly define concerns that appear to have been raised in the APFF comments.**[17]**

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[1] BR #23 provides:

That, for dispositions of shares occurring on or after Budget Day, the Act be amended to provide that if a specified individual would otherwise be required to include in computing income a capital gain from a disposition of shares of a corporation that is part of a transaction or event, or series of transactions or events, that includes an acquisition of those shares by a person who does not deal at arm's length with the individual and the individual would be subject to the tax on split income in respect of dividends on those shares, then

(*a*) for the purposes of computing the income of the individual under the Act

> i. the amount that would otherwise have been the individual's capital gain in respect of the disposition will be deemed to be a taxable dividend received by the individual,
>
> ii. section 120.4 of the Act will apply to the taxable dividend, and
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> iii. the taxable dividend will not be an eligible dividend; and

(*b*) the corporation will be considered not to have paid a dividend for the purposes of the Act.

[2] See document number 2010-0373621C6. This French only document contains views of the CRA provided in question 34 of the 2010 APFF Round Table regarding what the CRA views as abusive uses of family trusts.

[3] Some might not agree that this type of planning, though quite common, has reached the status of true plain vanilla planning. For those of you in this camp please forgive the literary license taken by me.

[4] Unless otherwise noted all statutory references are to the Act.

[5] Interestingly, the spousal attribution rules in section 74.2 would generally apply to capital gains.

[6] This phrase presumably pertains to exemptions designated by subsection 104(21.2) to a trust's beneficiaries.

[7] A high/low stock dividend could be paid on common shares held by a family trust (subject to applicable corporate law), i.e., such that the taxable dividend will be restricted to the increase in stated capital, which would also be the acb of the high/low share. The trust would then sell the share at the redemption price (e.g., to a parent in consideration for a promissory note), triggering the capital gain to the trust, which would be allocated to the beneficiaries in order to utilize low marginal tax rates. The purchaser of the shares would sell the high/low share to a Holdco connected with the corporation that paid the stock dividend, e.g., in consideration for a promissory note from Holdco. The shares would then be redeemed and the proceeds would be used to repay the promissory note to the parent and then to the family trust, which would distribute the proceeds to the beneficiaries.

[8] It is worth noting that the comments in Annex 3 of the Budget appear to focus on a non-arm's length disposition of the shares rather than the non-arm's length acquisition focus of BR #23.

[9] If the minor personally acquires shares directly it appears that BR #23 would not be applicable.

[10] In the eyes of the CRA, at least, one possible factor that could be indicative of the third-party sale being part of the same series of transactions as the original freeze is whether purification structures are put in place at the time of the freeze. In the past, the CRA has stated that it would be difficult for a taxpayer to maintain that he or she had no intention of every selling the purified shares at the time of purification reorganization, such that the sale would be part of the same series. See, for example, Doc. Nos. 5-7939, June 30th, 1989 and 9430255, March 9th, 1995.

[11] 2009 DTC 5101, FCA.

[12] There continue to be many good reasons for taxpayers to crystallize their capital gains exemptions, including protecting against a corporation's shares ceasing to be qualified small business corporation shares, which can occur for a variety of reasons.

[13] Subject to any potential alternative minimum tax liability.

[14] Also identified were the high/low stock dividend "transmogrification transactions" discussed earlier and subsection 75(2) corporate strips.

[15] 2010 DTC 5172.

[16] My partner David Louis initially wrote about this phenomenon before it was known to be a "targeted" project of the CRA in his October, 2010, Tax Notes article, "Tax Grazing: Questionnaires, Wills and Leaky Pipelines". More recently, all of the major accounting firms have issued releases on this subject. For example, see KPMG's Tax News Flash- Canada dated January 31, 2011, No. 2011-02, "New CRA Project Targets High Net Worth Individuals."

[17] On the date this article was to be submitted the CRA released a number of additional French only technical interpretations and other documents, including document #2010-0374211R3. This document is a withdrawn ruling request in respect of what appears to be sophisticated inter-generational tax planning intended to tax effectively monetize the retiring parent to "cash out" his or her capital gains exemption. Of particular interest are the CRA's comments in the third last paragraph of the document that their general position with respect to situations designed to monetize a person's capital gains deduction, among other types of transaction, through one or more internal transactions that permit a taxpayer to retains the same economic interests after the transaction or transactions with family members acting as accommodators or facilitators will be considered to be abusive and the CRA will seek to apply section 84.1 and / or the GAAR, as the case may be. I'm not really sure this represents anything new, though it is consistent with the trend that the CRA appears quite concerned with many forms of tax planning involving, among other things, what it considers to be abuses of the capital gains exemption rules.