CCH Tax Notes – August

My Final Answer (For Now)

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This month, I would like to follow-up on some of my articles that have appeared in this newsletter in the last year or so.

2011 Federal Budget – Some Additional Reflections

In my May article ("Freeze Structures – Under Attack"**[1]**) I talked about a 2011 federal Budget proposal - Budget Resolution #23 - clamping down on capital gains splitting with minors. In retrospect, however, I see this proposal as just an example of what appears to be a growing initiative against tax planning for entrepreneurs, their families, and their businesses.

The budget proposal itself extends the "kiddie tax" to would-be capital gains from a disposition of shares of a corporation by a minor, if part of a series of transactions that includes the acquisition of such shares by a non-arm's length person.**[2]** As I indicated in the article, a sale occurring under a standard estate freeze structure would be caught by these rules (even if the freeze was implemented prior to the budget), provided that the sale takes place on or after the budget**[3]** and the sale is part of the same series as the implementation of the freeze itself**[4]**.

A troubling aspect of the proposal is the uncertainty that it creates. If a garden variety freeze is put into place, when might a capital gains exemption claim be challenged by the CRA – i.e., on the grounds that the sale is part of the same series as the freeze? What if the sale is unforeseen? Does it matter if purification structures are put into place, - i.e., so as to allow the corporation's shares to constantly qualify for "small business corporation" status (i.e., continually maintain eligibility for the capital gains exemption in case a buyer comes along)?**[5]** The situation may be clarified when the Supreme Court of Canada finally releases its verdict in the long-awaited Copthorne case, but as things stand at the moment, it is often difficult to advise a client as to the likelihood of success.**[6]**

As most readers will be aware, when it comes to tax planning for owner-managers and their businesses, the federal Budget didn't stop there. It also eliminated the deferral for corporations that have a significant interest in partnerships having fiscal periods which differ from the corporation's taxation year. More recently, the CRA indicated that taxpayers that enter into joint-venture arrangements will no longer be eligible to compute income as if the joint venture had a separate fiscal period.**[7]** The federal Budget also announced that the government will be reviewing Employees Profit Sharing Plans; meanwhile, the CRA has an audit initiative relating to Retirement Compensation Arrangements. Budget proposals relating to RRSPs may result in severe tax penalties in many owner-manager situations, particularly, where shares of a closely-held private company are held by an RRSP: where an individual and related parties have an interest in 10% or more of a corporation, its shares will become a "prohibited investment" for RRSP purposes. Unless such investments are liquidated by the RRSP before 2013, there will be a tax based on 50% of the fair market value of the investment at the time it becomes a prohibited investment.**[8]**

While it is difficult to be overly critical about some of these changes, when you put together the various government initiatives against owner-managed businesses, a different perspective may emerge. In previous newsletters, I have written about the CRA's increased attention to high-net-worth individuals, as well as family trusts. In the former case, for clients that have not reached the exalted $50M level at which you may be singled out for special attention, I would not be so sure that the CRA's initiative won't morph into a lower wealth level, especially if the CRA's current fishing expedition on the wealthy finds tax planning strategies which are not to its liking. Recently, when the

CRA was asked about its initiative on family trusts, it indicated that it "intends to continue its focus on inter vivos trusts since results achieved to date indicate that there are significant compliance risks associated with the use of trusts."**[9]**

Personally, I think that these initiatives have reached the point that they warrant the attention of organizations that represent owner-managed businesses.

The Endnote that Became an Article

In March and April, I wrote a two-part article about tax traps that can arise in commonplace transactions**[10]**; examples include loans to non-resident corporate shareholders, situations where assessment limitation periods are more lengthly (sometimes infinite), and so on. As work on the article progressed, it became apparent that each trap I discussed was, itself, a full-blown topic, replete with its own technical nuances, CRA pronouncements, and so on.

In fact, one issue that became contentious was buried in an endnote. The issue relates to the timing of additions to the capital dividend account when there is a disposition by a corporation of eligible capital. Even the general rule - that CDA does not materialize until the end of the corporation's taxation year**[11]** – can be a dangerous trap.**[12]** The endnote in question indicates that an election under subsection 14(1.01) - which generally applies the capital gains rather than the eligible capital regime to qualifying amounts - can be made with a CDA election so that, at time of filing, the appropriate amount will be added to the CDA. Otherwise - my note goes on to say - the CRA's position appears to be that the CDA will increase at the time the subsection 14(1.01) election is filed with the corporation's income tax return. The last statement seemed to be inconsistent with other commentary that appeared to indicate that, if the subsection 14(1.01) election is filed with the corporation's income tax return, the addition to the capital dividend account will occur at year end**[13]**. However, in the April issue of Tax for the Owner-Manager, another article appeared**[14]**, clarifying that in the absence of subsection 14(1.01) election filed concurrently with the capital dividend election, the CRA's position is that the CDA would not materialize until the tax return for the particular year is filed.

The CRA's positions relating to the recognition of the capital dividend account are fraught with complexities:

- General rule – the CDA from disposition of eligible capital by a corporation does not materialize until its year-end.
- If a corporation is a member of a partnership that has sold eligible capital property, the CDA materializes at the end of the partnership's fiscal year, rather than at the corporate partner's year end**[15]**.
- If a trust is flowing-out capital dividends to a corporate beneficiary, the CDA does not materialize until the end of the trust's taxation year**[16]**.
- A subsection 14(1.01) election can be filed with the CDA election, at which time the CDA will be enlarged. If this is not done, the CDA will not be enlarged until the corporation's tax return is filed.

Of course, the time when the owner-manager wants the CDA is usually none of the above – it's when the cash comes in, typically, before the CDA is enlarged per the CRA policies above. So the proclivity to pay out the CDA when the cash comes in creates a dangerous tax trap.

Rethinking RRSPs (Some More)

My final remarks are made with trepidation, because they are based on some simplistic calculations. In December, I wrote about a study which challenges a long-standing axiom of owner-manager remuneration – that you should pay yourself enough salary to max out on your RRSP contribution**[17]**. A release by the CIBC Private Wealth Management Group ("Rethinking RRSPs") contends that it is better to fund personal and living requirements with dividends, leaving excess cash to be reinvested in the company, as opposed to paying salary required to max out on the RRSP contribution: When you compare the amount of dividends that must be distributed from corporate-earned income in order to leave an owner-manager in the same after-tax cash position he or she would be in if a salary sufficient to maximize RRSP contributions had been paid**[18]**, there is enough extra cash left in the corporation to overcome the tax-deferred features of an RRSP.

The "detailed example" in the report showing the numerical results under various assumptions indicates that payroll taxes, including CPP contributions, are ignored. CPP contributions are a material amount in respect of the salary alternative. In fact, it appears that the extra cash left in the corporation under the dividend alternative is fairly similar to the required employer/employee CPP contributions. When we tried some calculations to build in the effect of CPP contributions and benefits on a very simplistic basis, we found that the dividend alternative is still generally preferred.**[19]** However, our assumptions were extremely simplistic. For further comments on our study, see the Beanstalk Blog www.beanstalk.ca, in particular a piece by Minden Gross's Matthew Getzler on May 2, 2011.

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[1] *Tax Notes*, No. 580.

[2] The proposal applies if the minor would be subject to the "kiddie tax" in respect of dividends paid on such shares. This would include shares of any private corporation. The would-be capital gain is taxed as a (non-eligible) deemed dividend subject to the kiddie tax, so that it is taxed at the highest marginal rates.

[3] March 22, 2011.

[4] As indicated in the article, the budget initiative was "supplemented" by a statement from the 2010 APFF Round Table which seems to indicate that family trusts put in place to multiply the capital gains exemption may be perceived by the CRA to be abusive, such that GAAR may apply. The APFF question indicates that where in the context of a disposition of a taxpayer's shares, a structure comprising a family trust and participation by accommodating parties (this appears to refer to family members acting as accommodators or facilitators to the transaction.) is put in place with the goal of avoiding tax on capital gains resulting from the disposition of shares through the utilization of capital gains exemption, the CRA would view the structure as abusive.

[5] 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 ever selling the purified shares at the time of a purification reorganization such that the sale would not be part of the same series. See, for example, Doc. Nos. 5-7939, June 30, 1989 and 9430255, March 9, 1995.

[6] With respect to the Budget proposal itself, if a sale takes place when the kids are no longer minors, the resolution would not apply. But in this case, the APFF question noted above must be considered.

For further discussion, of Budget Resolution #23, see "Federal Budget 'Targets' Planning Involving Minors", Michael Goldberg, *Estate Planner*, April 2011 (No. 195), CCH Canadian Limited.

[7] Doc. No. 2011-0403081C6, 2011 Prairie Provinces Tax Conference.

[8] If an investment which is described in the new definition "prohibited investment" was acquired before Budget Day and is still held in an RRSP after 2012, it will be deemed to be a prohibited investment acquired on January 1, 2013.

[9] Doc. No. 2011-0398351C6, CLHIA Round Table, May 20th, 2011.

[10] Welcome to My Nightmare – Tax Traps/More Tax Traps, *Tax Notes*, Nos. 578 and 579.

[11] See paragraphs (c.1) and (c.2) of the definition of "capital dividend account" in subsection 89(1), as well as the preamble to subsection 14(1).

[12] Thus, the CRA has stated that the first day in which a capital dividend can be paid out is the first day of the following taxation year. See form T2054.

[13] I.e., so that the increased CDA could be paid out on the first day of the year following the year in which the disposition took place.

[14] "ECP Capital Gains Election Timing Critical for CDA Purposes", Deb MacPherson, *Tax for the Owner-Manager*, April 2011.

[15] See Doc. No. 2006-0215001E5, June 18th, 2007.

[16] See Doc. Nos. 2010-0363191C6 (2010 STEP Round Table Question 21) and 2010-0358471E5, May 3, 2010. Besides the trust having to be resident in Canada throughout the year, to be added to the corporation's CDA, the amount must be designated in respect of the corporation in the trust's tax return. Compare this position with the CRA's position on the 14(1.01) election, if filed with the corporation's tax return.

[17] "New Tax Commentary is Food For Thought", *Tax Notes*, No. 575.

[18] Hereinafter, the "dividend alternative".

[19] If there is a relatively high yield on interest (or other fully taxable investment income), our calculations showed that the salary/RRSP strategy could provide a somewhat better result than the dividend alternative, especially if combined with a lengthly holding period. However, the dividend alternative tends to be more attractive when substantial amounts of the investment income is subject to favourable taxation, e.g., as capital gains or Canadian dividends.