CCH

Tax Notes/Estate Planner - October

Succession Planning - Intergenerational Cash-Outs

Note: This article is adapted from the soon-to-be-published third edition of Tax and Family Business Succession Planning, by David Louis, Samantha Prasad and new co-author Michael Goldberg[1] *(CCH Canadian Limited).*

While the cornerstone of family business succession planning is the estate freeze[2], in some cases, it may be desired that the founder of the business be paid for his or her interest, within a freeze structure (usually by liquidating the freeze shares) or otherwise. If so, there are special opportunities to defer tax on an intergenerational cash-out within a family, which are not available in respect of third-party sales.

10-Year Reserve for Intergenerational QSBC Share Transfer[3]

Per subsection 40(1.1) of the Act, the normal five-year reserve is extended to ten years, where qualifying small business corporation shares are transferred to a Canadian-resident child or grandchild,[4] so that the minimum rate of recognition of the gain is 10% per year.[5] (Qualifying small business corporation shares are discussed in Chapter 4 — these are shares which are eligible for the $750,000 capital gains exemption, and generally include freeze shares.)

To qualify for the 10-year reserve, the transferee of the shares must be the child or grandchild. This appears to rule out a transfer of a qualifying corporation by a taxpayer's holding company or other indirect transfer. Likewise, it appears that the intergenerational transfer would not be available to a spouse, alter ego or joint partner trust. However, if shares were left outright to a spouse or common law partner (or an encroachment consisting of the shares were made from the aforementioned trusts), the reserve would be available if the surviving spouse effected an otherwise-qualifying intergenerational transfer. Also, there is no provision for a transfer to a trust in favour of such individuals, or to a holding company. However, since there is no holding period requirement, there appears to be no reason why the child or grandchild could not roll the shares into a holding company (in fact, this may be advantageous — see below).

The reserve on the unrecognized gain will be taxed on death,[6] but effectively can be ''rolled over'' to a surviving spouse or qualifying spouse trust.[7] While claiming the subsection 40(1.1) reserve will, of course, accelerate tax, the provision can nevertheless be quite useful in the right circumstances. One example, of course, is where ''the business deal'' is that there be an inter-vivos sale of shares to a child or grandchild. It should also be noted that, notwithstanding the reserve, the transferee would presumably obtain a full cost base in the shares. Unless a reserve was claimed in connection with a capital gains exemption claim,[8] the ability to use the cost base to access the corporation's assets on a tax-efficient basis will not be blocked by section 84.1. Therefore, it appears that (subject to possible GAAR considerations) the transferee could use the increased cost base to access corporate-level assets on a tax-efficient basis, e.g., by transferring his or her shares to a Holdco.[9]

Finally, it should not be forgotten that qualifying small business corporation shares may also qualify for the $750,000 lifetime capital gains exemption, which can be used in combination with the 10-year reserve discussed above.

Inter-Generational Corporate Cash Out[10]

Another tax-effective way for the Freezor to exit from the operating structure could involve Freezor transferring his or her frozen Opco shares to a Holdco on a tax-deferred basis and then causing Opco to redeem the frozen shares held by Holdco. This planning would permit Holdco to invest the redemption proceeds in such manner as Freezor desired without leaving the assets

subject to creditors of Opco. Provided that the frozen corporate group is comprised solely of related persons[11] inter-corporate redemptions will generate deemed dividends, which should not be subject to recharacterization as capital gains under subsection 55(2)[12]. Also, although it may be possible to redeem all of the Freezor's shares from the outset of the transaction, for corporate reasons[13] this may not be practical and, in addition, without careful planning, in some situations a full inter-corporate redemption may reduce the effectiveness of pre and post-mortem planning strategies intended to enable Freezor to minimize his or her death taxes.[14]
Rather than roll all of the freeze shares into a Holdco, one obvious variation is to retain sufficient freeze shares to utilize Freezor's capital gains exemption through an inter-vivos sale, or on death.

Special Opportunities from Eligible Dividends[15].

Where Opco has generated GRIP, the benefits may be enhanced by designating the deemed dividend as an eligible dividend out of GRIP, so that future dividends from Holdco to Freezor may qualify for lower tax rates. (It should be noted that the combined corporate/personal tax when income is taxed at full corporate tax rates and distributed as an eligible dividend is generally more or less equal to the tax that would be incurred had the income been earned directly by an individual, so this process will ultimately be largely tax-efficient. But until earnings are distributed to the individual shareholder as eligible dividends, there will be a significant element of tax deferral, so that the foregoing arrangement is quite beneficial where Freezor is cashing out.)

Of course, the ability of Freezor to cash out on a tax-efficient basis could be important if there are special cash requirements resultant from disability. In this and other cases where subsection 55(2) has not applied, the proceeds of the inter-corporate redemption will presumably be invested at the Holdco level, so as to preserve the deferral. The investment income may well generate RDTOH, with the earnings periodically distributed to fund personal and living expenses. In this case, the availability of GRIP – i.e., which may be resultant from the deemed dividend from the intercorporate redemptions between Opco and Holdco - will enable the dividend from Holdco to trigger a dividend refund, yet still maintain its status as an eligible dividend[16].
Tax and Family Business Succession Planning, 3rd Edition, may be ordered on the CCH website at www.cch.ca, or by Googling "Tax and Family Business Succession Planning".

---

[1] Davdi Louis; Samantha Prasad; Michael Goldberg.

[2] Rather than simply selling or gifting the shares of a corporation, for example, to the next generation, an estate freeze allows the owner-manager to set up a structure whereby the children are brought into the corporation (either directly or through a trust) without generating adverse tax consequences, while effectively freezing the value of the owner-manager's interest in the corporation at the time of the estate freeze, thereby limiting his or her tax liability on death.

[3] This material appears in Chapter 2, at 204a.

[4] See subsections 40(8) and 70(10).

[5] The deferral is also available in respect of qualifying farming and fishing transfers. If the sale is in consideration for a demand promissory note, it is prudent to insert a time lag prior to the expiration of which the note will not be payable. The possible application of section 69 should also be considered.

[6] See subsection 72(1).

[7] See subsection 72(2).

[8] Very basically, where the taxpayer or a non-arm's length person has claimed the capital gains reserve, for the purpose of computing the cost base for the purpose of section 84.1 (often referred to as the ''84.1 cost base''), subsection 84.1(2.1) is designed to treat the transferor as if the maximum capital gains exemption had been claimed and no reserve had been taken.

[9] Because the shares must be qualifying small business corporation shares, one would not expect there to be significant surplus assets in the particular corporation (initially at least). The cost base might be used to access liquid assets of other corporations; however, this would result in a situation reminiscent of Desmarais v. The Queen, 2006 DTC 2376 (T.C.C.), in which the taxpayer was successfully attacked under GAAR.

[10] This material appears in Chapter 2, at 204b.

[11] It is, however, critical that the exception to subsection 55(2) in paragraph 55(3)(a) apply; this should be reviewed carefully. For purposes of section 55, the concept of related persons is modified by subsection 55(5). Of particular importance is that pursuant to subparagraph 55(5)(e)(i) siblings are deemed to be unrelated persons. Also, pursuant to subparagraph 55(5)(e)(ii) a person who is related to every beneficiary of a trust (other than a registered charity) who is or may (otherwise than by reason of the death of another beneficiary of the trust) be entitled to share in the income or capital of the trust is deemed to be related to the trust. Based on the foregoing, it may well be the case that in a properly-implemented estate freeze, the trust and Opco will be related.

The introduction of Holdco into the structure requires further analysis, but happily it appears that, provided that the Holdco is an existing Holdco controlled by Freezor or a new Holdco of which Freezor is the incorporator and controlling shareholder, it should be possible to structure the planning so that Holdco will also be a related person. For more on this subject see CRA document numbers 970045 and 9626315, both dated July 7, 1998, as well as Vance Sider, CA and Marc Ton-That, CA "Understanding Section 55¨ and Butterfly Reorganizations" 1999 CCH Canadian Limited at page 90. Notwithstanding concerns raised by Sider and Ton-That, it appears that proposed amendment to clause 55(3)(a)(iii)(B) should also permit this problem to be solved where a shelf corporation is used (see Ted Citrome, "An Introduction to Paragraph 55(3)(a)," Report of Proceedings of Fifty-Eighth Tax Conference, 2006 Tax Conference (Toronto: Canadian Tax Foundation, 2007), 36:1-31 footnote 66).

[12] Part IV tax would apply if Opco obtains a dividend refund.

[13] For example, a redemption of all of the shares would almost certainly cause Opco to have to report significant deficits on its balance sheet, which might either preclude obtaining financing or might violate covenants in existing financial relationships. There may be ways of dealing with such issues, but these are beyond the scope of this discussion.

[14] For example, if Opco subsequently generates GRIP balances, depending on the structure used, there may be no effective way or Holdco to access such balances.

[15] The material appears in Chapter 11, at 1107, "Buy-sell options for liquidity events within the family."

[16] This could be even more effective in respect of distributions to individual shareholders than the application of subsection 55(2) which, may substantially tax-pay a distribution to an individual. For further discussion, with particular reference to disability issues, see Selected Aspects of Buy-Sell Provisions, Walter Benzinger, Doris Trevisani, and Karen Wilkinson, 2006 CR 35:1.)