Welcome to My Nightmare – Nasty Tax Traps

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It’s a horrible feeling - that just about everyone has gone through at one point or another. You’ve done a transaction, and everything seemed fine. Weeks or maybe months go by. You attend a seminar or read an article and something goes off in the pit of your stomach. You realize you have tripped over a tax trap.

In the next two articles, I will deal with some of the most dangerous tax traps. I hope you don’t get that feeling in your stomach. But if you do, next month’s article will have advice that I hope will be consoling.

Section 84.1

Most practitioners agree that this is the most dangerous tax trap around. It applies to everyday transactions and the result is counter-intuitive to basic tax principles.

In a nutshell, the application of section 84.1 in its worst form – an immediate deemed dividend - applies where the cost base created by the capital gains exemption claimed by you or a non-arm’s length person is used to access cash or other corporate-level assets[1]. This includes both the immediate receipt of such assets and a sale for a promissory note (in this case, the deemed dividend occurs when you receive the promissory note, not when it is repaid)[2].

Rather than go into the deadly-boring mechanics, perhaps a couple of common transactions will be more helpful in your memory. The first is if you attempt to crystallize your capital gains exemption by transferring some or all of your shares of a corporation to a Holdco in return for a promissory note from Holdco, e.g., for $750,000, the idea being that the corporation would pay a tax-free dividend to Holdco to repay the note. This results in an immediate deemed dividend because the Holdco note could otherwise be used as a “pipeline” to extract corporate cash, thus violating the section 84.1 principle: thou shalt not use the capital gains exemption to access corporate-level assets tax-free.[3]

Another common example is if you claim the exemption on a sale of shares to a non-arm’s length person’s holding company in exchange for cash or a promissory note equivalent to your available capital gains exemption. The cash or promissory note will be a deemed dividend. An even more insidious example is if you sell to a relative[4] for cash or a promissory note, and the relative tries to access corporate-level assets by selling the shares to a Holdco, e.g., for a promissory note. In that case, the relative has the deemed dividend.[5]

Capital Dividend Account

There are a number of tax traps relating to the capital dividend account. For example, the capital dividend account from the disposition of eligible capital by a corporation does not materialize until the end of the vendor corporation’s taxation year[6]. I have seen situations where the tax advisor has previously learned about this rule, but forgets it in a future transaction. The rule is so counter-intuitive that it is easy make this mistake, especially since the shareholders of a corporation selling its assets often can’t wait to take the money out of the company and a capital dividend will be declared virtually in the heat of closing the deal.

The CRA has recently indicated that if a trust is flowing out capital dividends to a corporate beneficiary, the capital dividend account does not materialize until the end of the trust’s taxation year.[7] On the other hand, a fairly recent Technical Interpretation[8] indicates that where a
corporation is a member of the partnership that has sold eligible capital property, the CDA materializes at the end of the partnership’s fiscal year, not at the corporate partner’s year-end, as would be the case if the corporation directly owned the asset.

When does the CDA pass-up to a holding company? The dividend must be actually received by the Holdco; a journal entry will not suffice. Similarly, if a distribution is by promissory note, it is best to document the note as being absolute payment of the dividend. Also, capital dividends paid to non-residents are wasted, as they attract Canadian withholding tax. It is possible to “stream” capital dividends to Canadian resident shareholders. If a corporation distributes tax-free capital gains as a capital dividend, and then has offsetting capital losses, it will be necessary to “replenish” the CDA with capital gains or other positive components before tax free dividends can be paid. If the “CDA hole” is big enough, consider reorganizing such that future CDA is generated in another corporation outside of the particular corporation (or downstream companies).

On the bright side, the CRA’s policies pertaining to the disallowance of CDA where there is an absolute assignment of insurance as collateral for a loan have been overridden in the case of Innovative Installation, so that the assignor of the policy gets the CDA in this case.

Although this article relates to tax traps, I thought I should point out a couple of opportunities in respect of CDA. Several of the components of the CDA calculation cannot be negative amounts. Effectively, negative amounts are “quarantined” from other elements of the definition. For example, if a corporation has overall capital losses but a positive balance in respect of eligible capital property, the negative capital loss balances will not erode the capital dividend account generated by the gain from eligible capital property. Of course, subsequent capital gains would simply “backfill” the negative amount. Ordinary losses do not figure in the CDA. For example, a corporation with ongoing business losses which incurs a capital gain will have a full CDA; another likely candidate in the business loss scenario could be a gain from eligible capital property. (Note that the business losses would erode the refundable tax on hand account.)

**Rollover Traps**

As everyone knows, section 85 and subsection 97(2) provide for tax-deferred rollovers of most assets into corporations or partnerships. (In the former case, a notable exception is real estate inventory; restrictions on the ability to roll over FIEs have vanished because of the withdrawal of the FIE proposals.) However, one dangerous tax trap relates to assets which have changed from capital to inventory. If such property is sold, a portion of the appreciation based on the value at the time of the change of use can be claimed as a capital gain. Suppose the property is first rolled into a partnership, based on its original cost base. Under basic rollover rules, the partnership would, of course, inherit the transferor’s tax cost. But would it be able to claim the value to the date of the change of use as a capital gain? Under basic principles, it would seem that, since the partnership is treated as if it were a separate taxpayer, this would not be the case, so that capital status would be lost and the entire gain would be reported on income account by the partnership. Unfortunately, this was recently supported in Bodine v. The Queen.

Another tax trap arises – most often for the transfer of real estate – if the mortgages and other indebtedness to be assumed exceed the tax cost of the assets being transferred. In that case, the excess amount assumed will be a capital gain. This should be checked out before the transfer. (If an amount equal to the excess were treated as owing to the corporation, this would trigger the shareholder loan rules and in some circumstances may run afoul of CRA policies which appear to be directed against effectively receiving non-share consideration in excess of the elected amount through related transactions.) In these circumstances, another thing to be reviewed is whether consents must be obtained from mortgagees and, where applicable, the CMHC (i.e., if the mortgage is insured).

Of course, the discussion above only scratches the surface of issues that can arise on a rollover. For example, where there are other shareholders of the corporation, the attributes of the shares received on the transfer must be tailored so as to avoid benefit issues. On a less “elegant” note, I
have seen section 85 “rollovers” where practitioners are of the mistaken view that the issuance of promissory note for nearly the entire value of a transferred asset plus a single common share, i.e., having only a nominal value, can “kosher-up” a rollover.

**Assets Distributed From a Trust**

Normally, if shares of a business or other assets are distributed from a family or other inter vivos trust, this occurs on a rollover basis. However, there are a couple of instances in which this isn't the case. The first is where such shares and most other types of property are distributed to a non-resident beneficiary.[20] In that case, the rollover will be restored if the distribution is made to a Canadian resident corporation held by the non-resident beneficiary. If the trust does not provide for a corporate beneficiary, possible alternatives involve varying the trust to add such beneficiaries or the beneficiary assigning his or her interest in the trust to a corporation; however, certain tax issues (beyond the scope of this article) should be addressed for either alternative.

A more insidious trap is that the normal rollover – even to a resident beneficiary – will not apply if the so-called “reversionary trust rules” in subsection 75(2) have ever applied to the trust. I dealt with this issue in the June edition of Tax Notes[21], so I will not go into further detail. However, we find that this can be particularly problematic for trusts that are now reaching their 21st anniversary. This is because “on average” it is more common for older trusts to trip over the reversionary trust rules than newer trusts. The early 90s were an era where when the consequences of tripping over these rules was not always fully appreciated by some practitioners.[22]

**Corporate Attribution Rules**

The corporate attribution rules can be a significant tax trap in attempting to use a corporate vehicle for income splitting. They potentially apply where an individual has directly or indirectly transferred or loaned assets to a corporation. For the rules to apply, one of the main purposes of the transfer or loan must be to reduce income of the individual and benefit[23] a “designated person”, including spouse, or a child or grandchild who has not reached the age of 18 in the year. These rules may impose taxable benefits in the form of deemed interest, based on the amount of the loan or transfer. As this is an ongoing taxable benefit, the effect of the corporate attribution rules can be quite severe, at least when prescribed interest rates are relatively high. (The taxable benefits will not apply during the period when the company qualifies as a “small business corporation”.) A corporate reorganization can be classified as a transfer, e.g., where shares are transferred to a holding company, or exchanged for other shares of the company.[24] Therefore, the corporate attribution rules can apply both to estate freezes which involve transfers to holding companies as well as those involving a direct reorganization of the capital of the corporation itself.

The application of the corporate attribution rules can be surprisingly straight forward. Suppose, for example, that a corporation is formed with family members including designated persons as shareholders, either directly or through a family trust. Mother, who has a sizable amount of cash available for investments, decides to transfer the cash to the family company by way of an interest-free loan. Arguably at least – and subject to the purpose test mentioned above - the prerequisites to the corporate attribution rules may apply to this simple situation: by transferring the cash to the corporation, Mother has reduced her investment income, and as the income will accrue to the family member shareholders, the transfer benefits the family members.

There are two common antidotes to the corporate attribution rules. As I mentioned, the rules will not apply to periods when the corporation qualifies as a small business corporation. Trouble is, if a significant portion[25] of the corporation’s asset base is used in investment rather than business activities, the small business corporation exception may no longer apply, until such time as small business corporation status is restored. (Strategies can be devised to continually jettison non-qualifying assets on a tax-efficient basis.)
The other antidote applies where the interest of designated persons are held exclusively through a trust. The trust must contain a blanket prohibition on the use of income of capital while “designated person” status applies.[26]

As I wrote in my December article[27], “derivative transfer” rules may extend the application of the corporate attribution rules. They potentially apply when an individual has, first, transferred or lent property to his or her corporation and that property (or substituted property) is in turn transferred by the corporation to another corporation in which family members who are “designated persons” are significant shareholders. As long as the property in the first corporation (or substituted property) ends up in the transferee corporation, these rules can potentially be applicable - even if the second transfer takes place years after the first transfer and is completely independent thereof. This could apply in the case of a “reverse” or “downstream” freeze.

The corporate attribution rules appear to be a huge tax trap for the unwary. Interestingly, though, I can find only one reported tax case in which the application of the corporate attribution rules was argued in tax court.[28] Perhaps this is because of the purpose test requirement mentioned earlier[29].

Continued Next Month.

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[1] A similar result may occur where an individual seeks to realize such corporate-level assets based on cost base attributable to V-day value increment in share values.

[2] Section 84.1 applies when a taxpayer resident in Canada, other than a corporation, disposes of a share of a corporation resident in Canada (“the subject corporation”) that is capital property, to another corporation with which the taxpayer does not deal at arm’s length, provided that the “purchaser corporation” and the subject corporation are connected immediately after the transfer. A vendor will be treated as not dealing at arm’s length with a purchaser corporation in a situation where immediately before the disposition, the vendor is part of a group of five or less persons controlling the subject corporation and immediately after the disposition, the vendor was a member of a group of five or less persons controlling the purchaser corporation, provided that the members of the first controlling group are also the members of the second controlling group. Rather than a deemed dividend, section 84.1 may be operative to reduce paid-up capital.

[3] Juliar, the groundbreaking case on rectification (2000 DTC 6589, OCA) involved taxpayers who tripped into this trap. The case involved obtaining an order rectifying the transaction in order to “transmogrify” it into a share exchange with “Holdco”.

[4] I.e., a related or other non-arm’s length person.

[5] To be applicable, the corporate transferee must be non-arm’s length to the individual transferor. In addition to related persons being deemed to be not at arm’s length, it is also possible to be factually not at arm’s length, such as where there is a directing mind, de facto control, or parties who act in concert. In a number of technical interpretations fairly early in the last decade, the CRA made it clear that it has not lost sight of this. However, the CRA has had mixed results in tax court in such situations. (For further discussion, see page 117 of Implementing Estate Freezes, David Louis and Samantha Prasad, 2006 CCH Canadian Limited.)

[6] 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). The CRA states that the first day on which a capital dividend can be paid out is the first day of the following taxation year (see form T2054). However, where applicable, an election under subsection 14(1.01) (which generally applies the capital gains rather than the eligible capital regime) can be made with a CDA election, at which time the appropriate amount will be added to the CDA (otherwise, 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; see, for example, the seventh bulleted point in form T2054).
The CRA’s position is that capital gains or losses from the operation of subsection 39(2) (i.e., if the gain or loss is solely attributable to the fluctuation of the currency of a country other than Canada relative to Canadian currency) will affect a corporation’s CDA at the end of the year. See Doc. No. 2007-0234691I7, July 23, 2007.

[7] Subsection 104(20) requires that the trust must be resident in Canada throughout the taxation year during which the trust received a capital dividend. Therefore, this condition will not be met until the end of the trust’s taxation year. Furthermore, a trust cannot designate an amount under subsection 104(20) before the end of the year. See Doc. No. 2010-0363191C6 (2010 STEP Round Table Question 21) and 2010-0358471E5, May 3rd, 2010.


Per the July 16, 2010 proposals, CDA will not be enlarged to the extent that capital gains from shares are generated because of the lack of increase in acb due to proposed paragraphs 52(3)(a) and 53(1)(b) (which prevent such cost base increases from non-taxable intercompany stock dividends and increases in PUC, respectively).

[10] Per Banner Pharmacaps, 2003 DTC 5642 (FCA), this wording may not be necessary. The Federal Court of Appeal indicated that the legal effect of delivery of a promissory note depends upon all the relevant facts, the most important of which is the intention of the maker of the note as determined by the evidence. In the particular case, the most important evidence was the resolution declaring the dividend. Having said this, the “absolute payment” phraseology is preferable.

[11] See “The Best Things In Life are (Tax) Free: A Current Look at The Capital Dividend Account”, Stewart Hoegner, 2002 CTJ 4 p.1435/6. Streaming can be achieved by redemption of shares (although this obviously may give rise to issues pertaining to disparities of shareholdings) or the use of separate classes of shares (where the shareholdings are reorganized or otherwise acquired to allow for streaming, the subsection 83(2.1) anti-avoidance rules should be considered). It should generally be possible to stream CDA to particular beneficiaries of a discretionary trust, as long as the wording of the trust allows this (i.e., the trust is “fully discretionary”). See Doc. Nos. 2001-0112945, March 19, 2002 and 2005-0116041E5, January 16, 2006.

[12] An ABIL is treated as a capital loss in the CDA computation.


[14] 2009 DTC 1388 (TCC); aff’d 2010 DTC 5175 (FCA).

[15] Subsection 83(2.1) converts what would otherwise be a capital dividend into a taxable dividend where one of the main purposes of acquiring a share (or a share substituted for such a share) is to receive a capital dividend. For further discussion, see “Subsection 83(2.1): The Capital Dividend Anti-Avoidance Provision”, by Perry Truster, Tax for the Owner-Manager; Canadian Tax Foundation, January 2001 (Vol. 11 No. 1). As Mr. Truster points out, conceptually at least, these rules potentially apply to a simple rollover to a Holdco.

[16] See also Doc. No. 9729995, June 26, 1998, wherein. a corporation had the following events: tax-free portion of capital gain $150,000; capital dividend, $140,000; non-deductible portion of capital loss, $200,000; non-taxable portion of eligible capital property gain, $300,000. The CRA confirmed that the CDA after these events was $160,000, because the capital gains component could not be negative.


If depreciable property held prior to V-day is transferred to a corporation or partnership, although the benefit of the tax-free zone in respect of pre-1972 assets carries over to the transferee (see ITARs 20(1.2) and 25(5.2)), there are no analogous rules that apply to the consideration (e.g., shares) received from the transferee. Where depreciable property (e.g., a building) is transferred, it is usually desired that the elected amount be restricted to the UCC of the asset.

[19] See Doc. No. 2000-0039335, September 27, 2000. See also (for example) Ceco v. The Queen, 2006 DTC 3006 (TCC) and Haro Pacific v. The Queen, 90 DTC 6583 (FCTD) in which the CRA has been successful in
respect of structures where taxpayers effectively received non-share consideration by virtue of “collateral transactions”.

[20] Per subsection 107(5), exceptions apply for property described in subsections 128.1(4)(b)(i) to (iii), including Canadian real estate and resource properties, assets used in an active business carried on through a permanent establishment in Canada, and “an excluded right or interest” as defined in subsection 128.1(10). Pursuant to the restrictions to taxable Canadian property in the 2010 federal Budget, it is no longer necessary to obtain a clearance certificate with respect to the disposition of a beneficiary’s interest in a trust unless the trust is primarily real estate or resource based.


[22] If the application of the reversionary trust rules is an issue, there may be ways to deal with it.

[23] Either directly or indirectly, by means of a trust or by any other means whatever. As observed in Garron (sub nom St. Michael Trust Corp. v. The Queen), 2010 DTC 5189 (FCA), this phrase has a very broad meaning. In the context of paragraph 94(1)(b) (the acquisition of property by a non-resident trust), the Court indicated:

. . .Parliament chose the words “directly or indirectly in any manner whatever” in paragraph 94(1)(b) deliberately to capture every possible means by which the wealth and income earning potential represented by the shares of a Canadian corporation can move to a non-resident trust from a Canadian resident beneficiary of the trust or a person related to that beneficiary. [par. 80]

[24] Subsection 89(9) provides that the redemption, acquisition or cancellation of a share is treated as a disposition of the share to the corporation.

[25] As most readers are aware, the normal benchmark is that small business corporation status will arise for a CCPC where at least 90% of the corporation’s assets are used in an active business carried on primarily in Canada; however, there is a “laundry list” of assets not regarded by the CRA as qualifying in this respect.

[26] For particulars, see subsection 74.4(4).


[28] Gehres v. The Queen, 2003 DTC 913 (TCC); the issue was not pursued as a result of a procedural defect.

[29] See, however, previous note on the Garron case.