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SELECTED TAX ISSUES AND TRAPS ASSOCIATED WITH ESTATE FREEZES

— *Michael Goldberg, Minden Gross LLP*

This is the fourth instalment in a series of articles discussing issues and traps practitioners need to navigate to successfully implement and maintain an estate freeze. This article will review the corporate attribution rules in section 74.4 of the *Income Tax Act* (the "Act").[1]

The Corporate Attribution Rules

These rules are intended to deter income and capital gains splitting with "designated persons",[2] which might otherwise be achieved through direct or indirect loans or transfers of property by an individual to a corporation; and they do so by giving rise to deemed income inclusions in the hands of the lender or transferor, as the case may be.

Estate freezes need to be carefully designed to avoid these rules. The bad news is that, unchecked, these rules can significantly undermine the benefits of an estate freeze. This is because the deemed income inclusion can create double taxation, since it will only result in tax in the freezor's hands and will have no impact on the frozen corporation or its other shareholders. The good news is that with careful planning, it is generally possible to implement estate freezes without going offside of these rules or to make their negative effects manageable.

Prerequisites to Application — The Preamble to Subsection 74.4(2)

The rules are quite complex but, in general, they will not apply unless it can first be established that there has been a direct or indirect loan or transfer of property by an individual to a corporation where one of the main purposes of the loan or transfer can reasonably be considered to have been to reduce the income of the individual and to directly or indirectly benefit a designated person.

The reduction of income of an individual has generally been accepted to include the reduction not only of ongoing income but also of an individual's potential future capital gains and death tax exposure. As to the concept of transfer, it has generally been accepted to be broad enough to apply to most standard forms of estate freezes implemented under any of sections 51, 85, or 86. It is also possible that these rules could catch intercorporate freezes (sometimes called downstream or reverse freezes), even in situations where an individual had transferred property to the freezor corporation many years previously.[3]

Personally, I have found that the application of section 74.4 can pose some significant challenges in situations where both spouses are pre-existing shareholders of a corporation that is to be reorganized as part of implementing an estate freeze.[4] Based on my experience, it is often quite difficult to eliminate these risks, but with care and attention, the exposure can often be minimized.

Further Conditions for Application

If the prerequisite for applying subsection 74.4(2) is met, then the corporate attribution rules will apply to any period or periods in a taxation year throughout which each of the following conditions applies:

(1) The designated person, whether he or she is a resident of Canada, is a "specified shareholder" of the corporation — which means that he or she has or is deemed to have more than 10% of the shares of any class of the corporation, and for this purpose, a discretionary beneficiary of a trust is generally deemed to own all of the shares held by the trust;[5]

(2) The transferor is a resident of Canada; and

(3) The corporation was not a small business corporation ("SBC").[6]

Generally, in a freeze situation the first two conditions will be satisfied. As a result, in most cases the only way to avoid section 74.4 will be to ensure that the corporation is an SBC at all times. Unfortunately, constantly maintaining a corporation's status as an SBC is often difficult, if not impossible, and as a result, attempting to avoid the corporate attribution rules based on SBC status can be risky.

Fortunately, there are other ways to avoid the application of the corporate attribution rules, and I'll comment on some of the ways to do this following a brief discussion of the calculation of how the corporate attribution income inclusion operates.

Computation of the Benefit

The periodic nature of the corporate attribution rules and certain technicalities in their drafting can make calculating the benefit quite tricky. In essence, the deemed income inclusion benefit of the lender or transferor for any particular period will be determined by multiplying the "outstanding amount"[7] of the loan or transfer by the prescribed rates in effect during that particular period. The outstanding amount is a complex concept that contemplates the ability to repay loans and to reduce the amount of the transfer under certain circumstances.

Once this income inclusion amount is determined, it will be reduced in the event that the lender or transferor actually received interest or dividends in the year[8] in respect of the loans or shares to which the corporate attribution rules would have otherwise applied. However, dividends deemed to have been received under section 84, for example, on share redemptions, will not reduce the income inclusion in any particular period.

Avoiding the Application of Section 74.4

Although paying interest or dividends on loans or shares may offer a relatively easy solution to the corporate attribution rules, particularly at today's low prescribed rates, in order to maximize the benefits of estate freezing, interest is often not paid on loans made by a freezor and dividends are often not paid on the freezor's frozen shares. Instead, reliance is often placed on section 74.4 not being applicable in the first place — for example, because the corporation is at all times an SBC, which, as I mentioned previously, may be a risky thing to do.

The Subsection 74.4(4) Exception

As an alternative, if neither of the options described above is available, planners should take steps to ensure that the freeze is implemented in compliance with the exception to the corporate attribution rules provided in subsection 74.4(4).

Subsection 74.4(4) deems all loans or transfers to a corporation *not* to have been made to benefit a designated person, provided that:

(1) The only interest of the designated person in the corporation is a beneficial interest in shares of the corporation held by the trust;

(2) By the terms of the trust, while an individual is a designated person, he or she can't obtain any benefit from the income or capital of the trust; and

(3) While the individual is a designated person, he or she must not obtain any actual benefit from the income or capital of the trust.

In order to comply with this provision, most practitioners will include an "anti-74.4" clause in their trusts that clearly complies with these requirements.

Unfortunately, while such clauses address the corporate attribution rules, the clauses may considerably restrict the benefits of estate freezing, particularly if capital gains exemption multiplication with minors or spouses is a motivating factor in entering into the freeze in the first place.

Stock Dividend Planning

It is generally accepted that the payment of dividends does not constitute a transfer to a corporation by its recipient shareholder.[9] Consequently, in appropriate situations it may also be possible to avoid the corporate attribution rules by using high-low stock dividends, which involve the issuance of shares with significant value but very little paid-up capital, to implement freezes and for other forms of planning. However, planning with stock dividends appears to have other possible risks associated with it, including the possible application of the general anti-avoidance rule in subsection 245 in some cases.

Notes:

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

[2] Per subsection 74.5(5), a designated person is an individual's spouse or a non-arm's length minor, including a nephew or niece.

[3] See subsection 74.5(6). For more on this topic, see Paul W. Festeryga, "Corporate Attribution: The 'Anti-Freeze' Rule" in "Personal Tax Planning," (2010) *Canadian Tax Journal* vol. 58, no. 3, 675-696 at 681.

[4] Spouses will be designated persons in respect of one another.

[5] See the definition of "specified shareholder" in subsection 248(1).

[6] As that term is defined in subsection 248(1).

[7] As that term is defined in subsection 74.4(3).

[8] Certain amounts included in the "split income" of a "designated person" will also reduce the income inclusion amount. For more information on these defined terms, please see Part III of this series of articles in issue no. 603 of *Tax Notes* (April 2013).

Interestingly, the language in paragraphs 74.4(2)(*e*) and (*f*) does not provide the 30-day grace period available in respect of the personal attribution rules in sections 74.1 and 74.2 and subsection 56(4.1) (for more on the personal attribution rules, please see Part II of this series of articles in issue no. 602 of *Tax Notes* (March 2013)). As such, it would seem that any interest or dividend amounts that are received by the lender or transferor at any time after the end of the year will not reduce the deemed income inclusion under the corporate attribution rules.

[9] See *Algoa Trust et al. v. The Queen*, 93 DTC 405.