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SELECTED TAX ISSUES AND TRAPS ASSOCIATED WITH ESTATE FREEZES

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This is the fifth and last 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 association rules in section 256 of the *Income Tax Act* (the "Act")[1] and the general anti-avoidance rule ("GAAR") in section 245.

Association Rules

Although the association rules can sometimes be relieving in nature, for example, by deeming property income to be active business income,[2] and by providing limited exceptions to both the "personal services business" and "specified investment business" rules,[3] in this article I'll only be discussing the negative impact that these rules can have on an otherwise properly implemented estate freeze.

In particular, the association rules can:

(1) result in corporations being forced to share a single small business deduction;[4]

(2) affect the ability of a corporation to claim certain scientific research and experimental development tax incentives;[5]

(3) cause corporations to share a single Part VI.1 $500,000 dividend allowance;[6] and

(4) cause associated groups in Ontario to be exposed to Ontario corporate minimum tax where total assets or gross revenues of the associated group exceed $50 million or $100 million, respectively.[7]

The association rules are extremely complex but generally involve elements of control and cross-ownership.

In an estate freeze each beneficiary of a discretionary trust will be deemed to own all the shares in the trust, and if the beneficiaries of the trust include minor children, 100% of the shares deemed to be owned by any particular child will be deemed to be owned by each of that particular child's parents.

In the latter case, a consequence of an estate freeze could be that while a child beneficiary is a minor, corporations in which that child's parents have interests that would otherwise not be associated with the frozen corporation[8] may become inadvertently associated with the frozen corporation.

The impact of the association rules in the former case is a bit more insidious, since most estate freezes are implemented at a time when beneficiaries are young and have

no business interests of their own. However, over the typical 21-year lifespan of a trust, children do grow up, and if they start up their own corporations, then the association rules could cause the frozen corporation and the child's new business corporation to be associated with one another.

GAAR

In this article the GAAR discussion will be limited to the application of the GAAR to standard estate freezes as well as to bail-out freezes and refreezes.

The good news is that although there has not been a lot of direct commentary by the CRA about freezes, the CRA has indicated that the GAAR would not ordinarily be engaged in garden-variety planning involving freezes, since the transactions should not constitute a misuse or abuse.[9]

Limited though they are, to date the CRA has generally made positive comments in connection with bail-out freezes, which are designed to permit the freezor to be a discretionary beneficiary of the family trust,[10] and in connection with refreeze transactions,[11] which usually involve making downward adjustments to the value of frozen shares where the frozen corporation itself has significantly decreased in value. Unfortunately, the CRA's comments have been less definitive than one might wish and are clearly open to being revisited depending on the facts. Having said that, anecdotally at least, bail-out freezes and refreezes appear to have become very common — one might even say plain vanilla planning — so it is hoped that the CRA will continue to be supportive of these practices.

Nonetheless, the CRA's views on the GAAR and the jurisprudence in connection with the GAAR continue to evolve, so the farther one veers off the well-trodden path, the more caution one should exercise.

Other Issues to Keep in Mind

This series of articles has only touched the surface of some of the major issues that planners must keep in mind when implementing estate freezes — there are many others.

For example, planners will certainly also need to be aware of:

- family law issues, which differ from province to province;
- issues that may affect the status of a corporation's shares as qualifying small business corporation shares eligible for the capital gains exemption;[12]
- potential issues relating to "taxable preferred shares" and "short-term preferred shares";[13] and
- issues that may affect freezes due to the mobility of beneficiaries of trusts, an issue that has become much more common with my clients, I've noticed, particularly in connection with beneficiaries who emigrate to the United States or who are Canadian residents but have US citizenship or green cards.

Notes:

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

[2] For example, see subsection 129(6).

[3] As these terms are defined in subsection 125(7).

[4] See subsections 125(2)–(5).

[5] See subsections 127(10.2)–(10.6).

[6] See subsections 191.1(2)–(6).

[7] See Division C of the *Taxation Act, 2007*, S.O. 2007, c. 11, Schedule A, as amended.

[8] A reference to a frozen corporation is intended to include a reference to an associated frozen corporate group of corporations.

[9] See, in particular, paragraph 10 of Information Circular 88-2.

[10] See Question 22 of the 1990 Revenue Canada Round Table.

[11] See CRA Document No. 2000-0050983, dated August 1, 2001.

[12] See section 110.6.

[13] As these terms are defined in section 248 and applied in Parts IV.1 and VI.1 of the Act.