Tax Notes

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SELECTED TAX ISSUES AND TRAPS ASSOCIATED WITH ESTATE FREEZES

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This is the second instalment of a series of articles discussing issue and traps practitioners need to navigate to successfully implement and maintain an estate freeze. This article will focus on the personal attribution rules.

The Personal Attribution Rules

The personal attribution rules are primarily found in sections 74.1 and 74.2 of the *Income Tax Act* (the "Act"),[1] as well as in subsection 56(4.1). Although the "kiddie tax" rules in section 120.4 might be lumped in with these rules, the kiddie tax rules will be discussed in the next article of this series. The personal attribution rules are intended to stop a taxpayer from creating a tax benefit by shifting income or capital gains from the taxpayer to a lower-taxed:

- spouse;
- non-arm's length person who is under the age of 18, including a minor who is the niece or nephew of the individual; or
- in some cases, other non-arm's length parties to the individual.

This is a process that is often referred to as income and capital gains splitting, and it is often one of the primary benefits that is hoped to be achieved in connection with implementing many estate freezes.

The personal attribution rules apply where a taxpayer directly or indirectly transfers or loans property to persons in the list above, whether through the use of a trust or otherwise; and depending on the applicable personal attribution rule, the rules will cause all of the income and in some cases all of the losses and/or capital gains and capital losses earned in connection with the property to attribute back to the taxpayer.

Consequently, estate freezes need to be carefully designed to avoid these rules. The good news is that with careful planning it is generally possible to implement estate freezes without going offside of these rules.

Sections 74.1 and 74.2

Section 74.1 will cause all of the income and losses from lent or transferred property that would otherwise have been earned in connection with such property by the taxpayer's spouse or non-arm's length minors, including nieces and nephews, to attribute back to the taxpayer. The sister provision to section 74.1 is section 74.2, which will cause attribution back to the transferor of all capital gains and capital losses that would

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otherwise have been earned by the taxpayer's spouse. Section 74.2 does not apply to minors.

There is no tax reduction or income-shifting purpose test required to engage sections 74.1 or 74.2 — the mere making of the loan or transfer to or for the benefit of a spouse in sections 74.1 and 74.2 and to or for the benefit of non-arm's length minors in section 74.1 will cause the relevant provisions to be applicable.

Subsection 56(4.1)

Subsection 56(4.1) is a less well-known personal attribution rule. When applicable, this provision will cause all of the income earned as a result of a loan made by a lender to non-arm's length persons to attribute back to the lender. However, subsection 56(4.1) will generally not apply if the loan is already subject to attribution under section 74.1, subsection 75(2),[2] or the kiddie tax. Subsection 56(4.1) does not cause capital gains or business income to attribute, and it also appears that it does not attribute any form of losses. And it applies only to loans, so transfers or gifts are not caught by this provision.

The most common application of subsection 56(4.1) is to adult children, but the rule can apply to other non-arm's length persons.

Unlike sections 74.1 and 74.2, subsection 56(4.1) contains a purpose test, and the rule only applies if "it can reasonably be considered that one of the main purposes for making the loan . . . was to reduce or avoid tax . . .".[3] As a result, no-interest loans that permit a taxpayer's adult children to acquire non–income producing properties — for example, a personal residence that is not used to generate income — will not be affected by these rules.[4]

Exceptions to the Personal Attribution Rules

Not all transfers or loans to or for the benefit of spouses, non-arm's length minors, or other non-arm's length persons are caught by these personal attribution rules. In particular, the personal attribution rules in sections 74.1 and 74.2 will not apply in any situation involving a transfer for fair market consideration.[5] However, when a sale is made by spouses, the spouses will need to elect out of the automatic rollover rules in subsection 73(1). If this provision is applicable, the property will be deemed to have been transferred on a tax-deferred basis, and the personal attribution rules will continue to apply.

If the fair market value consideration includes indebtedness,[6] or if instead of a transfer a "loan for value" is made,[7] none of the personal attribution rules discussed in this article will be applicable provided that:

(1) the indebtedness or loan bear interest at the lesser of the prescribed rate in place at the time that the indebtedness or loan is entered into and an arm's length interest rate at that time; and

(2) interest is paid on the indebtedness or loan no later than 30 days after the end of the particular year.

A failure to pay interest by the time limit in any particular year will cause this exception to cease to apply forever after.

Loans to finance active businesses are not caught by the personal attribution rules and do not need to meet the loan for value tests.

Although there are other exceptions to these personal attribution rules, the last exception that I'll comment on is that the personal attribution rules will cease to apply for any period or periods when the transferor is no longer resident in Canada or is deceased. In this regard, if a resident transferor who has previously become a non-resident subsequently becomes a resident of Canada again, it appears that the rules will again become applicable.

Notes:

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

[2] This provision contains the trust reversionary rules, which will not directly be dealt with in this series of articles.

[3] See paragraph 56(4.1)(*b*).

[4] See Brian S. Nicols, "Income Splitting," 1997 Ontario Tax Conference (Toronto: Canadian Tax Foundation, 1997), 2:1-62 at 19 for an excellent review of the rules in subsection 56(4.1).

[5] See subsection 74.5(1). The fair market value consideration exception is not relevant to subsection 56(4.1), since subsection 56(4.1) only deals with loans.

[6] See paragraph 74.5(1)(*b*).

[7] See subsections 74.5(2) and 56(4.2).