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SELECTED TAX ISSUES AND TRAPS ASSOCIATED WITH ESTATE FREEZES

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This is the third instalment of a series of articles discussing issues and traps practitioners need to navigate to successfully implement and maintain an estate freeze. This article will focus on the "kiddie tax" rules in section 120.4 of the *Income Tax Act* (the "Act")[1] and the trust attribution rules in section 74.3.

The Kiddie Tax Rules

Even if the personal attribution rules in section 74.1 do not apply to income earned by non-arm's length minors, a separate set of rules in section 120.4, the so-called kiddie tax rules, were put in place to further deter income splitting, and after March 22, 2011, capital gains splitting in respect of gains from share sales, with certain non-arm's length minors known as "specified individuals".[2]

In particular, the kiddie tax rules will result in certain kinds of income called "split income"[3] being taxed at top marginal rates without personal tax credits, which, depending on the province, can range from a low of 39% in Alberta to a high of 50% in Nova Scotia.[4] Please note that capital gains caught by the kiddie tax rules are taxed as though they were ineligible dividends, and as a result, minors caught by the kiddie tax rules will be taxed at rates across Canada ranging from a low of 27.71% in Alberta to a high of 41.17% in Prince Edward Island.[5] This is a significant penalty, considering that if the taxpayer rather than her minor children had earned the capital gains, she would have had to pay rates ranging from 19.5% in Alberta to 25% in Nova Scotia.[6]

Because many freezes that are put in place are intended to generate income and capital gains that will be split income, the kiddie tax rules will often significantly limit the ability to split income and capital gains with minors.

Key Concepts — "Split Income" and "Specified Individuals"

As the kiddie tax rules only apply to split income of specified individuals, it is important to have an understanding of both of these concepts.

Split Income

In general, split income includes dividend income and shareholder benefit income under section 15, whether derived from direct or indirect shareholdings, unless such income is earned in connection with shares of listed corporations or mutual fund corporations or from "excluded amounts".[7] Excluded amounts are income from properties inherited from a parent or income from properties inherited from any other person if the minor is either eligible to claim disability tax credits or enrolled in a post-secondary institution. As a result, direct inheritances from family members other than a minor's parents — for example, grandparents — will generally not be excluded property.

In addition, split income includes nearly all types of income derived from a closely held entity that is earned by a partnership or a trust and allocated to a minor.

The application of the kiddie tax rules to capital gains is narrower than to other forms of income and, in general, only non-arm's length direct or indirect share dispositions giving rise to capital gains taxed in the hands of minors will be caught by the kiddie tax rules. Exemptions to these rules are provided for non-arm's length transactions giving rise to capital gains from listed shares, mutual fund corporation shares, and excluded amounts. Interestingly, if the gains are not realized from direct or indirect share dispositions, the kiddie tax rules do not seem to apply.[8]

Specified Individuals

Having considered the types of income that are caught by the kiddie tax rules, it is still necessary to determine whether a minor is a specified individual, since only minors who are specified individuals are subject to the kiddie tax rules.

A specified individual is an individual who meets all three of the following tests:

(1) the individual is a minor who has not turned 17 before the taxation year — and in this regard, it is worth emphasizing that a minor who is 17 at some point during a particular year but turns 18 during that year will not be subject to the kiddie tax rules;

(2) the individual has not been a non-resident at any time in the taxation year; and

(3) the individual has a parent who was at any time in the year a resident of Canada.

If any of these criteria are *not* met in a taxation year, then the kiddie tax rules will not be applicable in that taxation year. However, if all of the conditions are met in a subsequent taxation year, the kiddie tax rules could become applicable at that time.

Relief from the Kiddie Tax Rules and an Ontario Planning Point

Pursuant to subsections 56(5) and 74.5(13), if the kiddie tax rules are applicable, then the personal attribution rules in subsections 56(4.1) as well as in sections 74.1 and 74.3 will not be applicable, and the reversionary trust attribution rules in subsection 75(2) will also not be applicable.

Because of Ontario's system of surtaxes, an Ontario minor caught by the kiddie tax rules will not pay tax at the highest Ontario marginal tax rates until the child's Ontario tax liability exceeds the Ontario surtax thresholds.[9] Savings from this type of planning are generally quite modest but are worth keeping in mind, particularly for Ontario taxpayers who are caught by the new top Ontario marginal tax rates.

The Trust Attribution Rules

The trust attribution rules in section 74.3 will not be applicable unless section 74.1 or 74.2 applies in the first place, and the trust attribution rules will only be applicable if a beneficiary of the trust is a "designated person" in respect of a person who has directly or indirectly lent or transferred property to the trust.

A designated person is defined in subsection 74.5(5) to mean a spouse, non-arm's length minor, or minor niece or nephew of the individual transferor or lender. Keep this term in mind as it is also used in the corporate attribution rules, which will be the focus of the next article in this series.

If applicable, section 74.3 provides rules for determining the amount of income and capital gains attributable from designated persons under sections 74.1 and 74.2 if the trust makes taxable allocations to beneficiaries who are both designated and non-designated persons.

In particular, the rules in section 74.3 will ensure that to the extent that income is allocated to designated persons, all income from transferred or loaned property is first allocated to the designated persons.

Notes:

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

[2] As defined in subsection 120.4(1).

[3] *Ibid*.

[4] In 2013, top rates will be nearly 50% in my home province of Ontario as well.

[5] Rates in Ontario will be 36.47% in 2013. Due to changes in the 2013 federal Budget, beginning in January 2014, the combined federal and provincial ineligible dividend rates will increase in all provinces, subject to any changes introduced as part of each province's budget. In Ontario, for example, as of January 2014, the top tax rate on ineligible dividends is currently projected to be 38.60%.

[6] Rates in Ontario will be nearly 25% in 2013.

[7] As defined in subsection 120.4(1).

[8] See subsections 120.4(4) and (5).

[9] Rates in Ontario will be 36.47% in 2013. Due to changes in the 2013 Federal Budget, beginning in January 2014, the combined federal and provincial ineligible dividend rates will increase in all provinces, subject to any changes introduced as part of each province's budget. In Ontario, for example, it would appear that unless there are further legislative changes, as of January 2014, the top tax rate on ineligible dividends is currently projected to be 38.60%, a rate that would appear to reintroduce disintegration back into the corporate tax system (and perhaps will be the subject of a future series of articles — stay tuned).