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Tax Grazing: Questionnaires, Wills and Leaky Pipelines

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In this article, I resume my habit of “tax grazing”, dealing with three developments which, besides the fact that I find them interesting, have no relationship to one another.

CRA Audit Questionnaire

A couple of weeks ago, I came across a CRA questionnaire, from a member of the “aggressive tax planning” division in a Toronto-area office, which was sent to the client as a precursor to an audit. In all probability, it is an evolution of the CRA’s response to 1999 and 2004 Auditor General’s reports claiming that the CRA has not focused on groups. I have seen similar questionnaires before, but compared to this one, they seem like lightweights. For one thing, it is specific about entities**[1]**, asking for details in respect of “unlisted” companies, private trusts, partnerships, joint ventures, and “further entities”, which include Charitable Foundations, as wells as Anstalts and Stiftungs (for example) - offshore entities, typically created under the laws of small European republics. (Yes, there is an emphasis on offshore assets.) In respect of trusts, the questionnaire goes beyond beneficiary status, asking for information about trusts in which the addressee (or in some cases a family member or entity named in the questionnaire) is a trustee, has a power of appointment, is a settlor or “appointor”, or has “control”**[2]**. Beyond financial statements and requests for an organization chart, the questionnaire asks for details of assets and liabilities of the various entities designated in the questionnaire. Besides asking for a rundown on personally-held investments, it also asks for accounts in which the addressee has signing authority.

Some quick e-mails to accounting colleagues and members of our Meritas Canada Tax Group suggested that many or most practitioners had not seen this questionnaire (although some had seen somewhat similar questionnaires)**[3]**.

If you have any interesting information or experience with this questionnaire, please send me an e-mail. There is no identification number, but it is twenty pages long, including two pages of definitions: you’ll know it when you see it.

Kaptyn – Specific Bequests of Corporate-Level Assets

The next interesting development will be discussed at greater length by my tax partner at Minden Gross, Joan Jung, in the upcoming issue of STEP Inside, the quarterly STEP Canada newsletter. The Kaptyn Estate case**[4]** involved a testator who purported to bequeath real estate to his grandchildren, as a “generation skip”. Trouble is, the deceased did not own the real estate directly, but it was owned by corporations of which he was shareholder. On application to the court, some parties advanced the position that the deceased’s gift failed because the testator did not own the assets at death**[5]**. But the court upheld the bequest on the grounds that the language used in the will was broad enough to pick up such an indirect interest**[6]**.

At the very least, the case is a reminder that it is important for the will drafter to understand the testator’s corporate structure, especially since testators may think of corporate-owned assets as their own. If a specific bequest is desired, enquiries should be made as to whether it is directly owned by the testator. If not, another important issue is the tax cost of distributing the property from

the corporation or other owner to the desired beneficiary, and who must defray it. (In Kaptyn Estate, the tax cost was to be borne by the estate, as opposed to the specific beneficiary.)

Pipeline – has it sprung a leak?

Another interesting development has to do with a post-mortem estate planning procedure that is generally known as a "pipeline". The pipeline procedure involves a fairly simple reorganization which takes advantage of the high cost base of shares held by the estate or beneficiaries (that is, created by the capital gains tax on death where the shares pass between generations) to create a "pipeline" to allow access to these assets on a tax-efficient basis. Typically, the shares in question, now having a cost base equal to fair market value, would be transferred to a Holdco in return for a promissory note from Holdco**[7]**; liquid corporate assets could then be distributed to the Holdco and then to the estate (or beneficiaries) as repayment for the promissory note.

The idea is that, on the transfer to Holdco and the repayment of the note, there would be little or no further tax (i.e., over and above the capital gains tax on death) because the estate had a bumped-up cost base in respect of the shares in question.

But is this the case? A recent article by Karen Yull**[8]** discusses a recent APFF Round Table Question (2009 APFF Round Table Question 1) which canvasses the possible application of subsection 84(2) to the payment of the promissory note.

Subsection 84(2) applies where funds or property of a resident corporation have been "distributed or otherwise appropriated in any manner whatever" to or for the benefit of shareholders of any class on the "winding-up, discontinuance, or reorganization of its business." If these pre-requisites apply, the corporation is deemed to have paid a dividend equal to the amount of funds or property in excess of the paid-up capital of the shares in question.

The key to the potential application of subsection 84(2) is that the estate is formerly the shareholder of Opco, and that funds/property have been "appropriated" to the estate through the repayment of the promissory note. Rulings have been granted on the basis that Opco (i.e., the corporation in question) would remain a separate and distinct entity for a period of at least one year before the pipeline is affected. In the APFF Round Table question itself, the CRA indicated that the foregoing was part of the proposed transaction submitted by the taxpayer and as such, cannot be considered as a requirement by the CRA.**[9]** The CRA indicated its position is to rule on the potential application of subsection 84(2) on a case-by-case basis, after a review of the facts and circumstances surrounding a specific situation.**[10]**

Versions of subsection 84(2) - an "anti-strip" provision - have appeared in the Income Tax Act for many decades. For example, rather than suffer the tax consequences of a deemed dividend, there would be an "accommodation party" that would purchase shares of an "Opco" with a liquidated business - in an amount based on the underlying assets, less a "fee" for participating in the transaction. This sort of transaction would be particularly lucrative before there was capital gains tax. More recently, RMM v. The Queen**[11]** involved such a transaction, whereby a US vendor claimed a treaty exemption of a sale of its subsidiary to RMM for proceeds reflecting cash and tax refunds. The CRA successfully applied subsection 84(2)**[12]**. This case makes an interesting comparison with McNichol v. The Queen**[13]**, a case with very similar facts, that came out just before RMM - and came to an opposite conclusion with respect to the application of subsection 84(2).**[14]**

While there is usually no mischief in a pipeline transaction, the structure is certainly reminiscent to the situations that potentially attracted the application of subsection 84(2) and its predecessors**[15]**. In RMM, Bowman, J. (as he then was) indicated:

> The words "distributed or otherwise appropriated *in any manner whatever* on the winding-up, discontinuance or reorganization of its business" are words of the widest import, and cover a large variety of ways in which corporate funds can end up in a shareholder's hands. [p.308]

In fact, in the case of a pipeline, Holdco is not even a third-party “accommodation party”, and (unlike some of the cases which attempt to “distance” the source of funds) the funds used to satisfy the promissory note usually emanate directly from Opco.

As mentioned above, it is a requirement of subsection 84(2) that there be a “winding-up, discontinuance or reorganization” of the business – i.e., held by the Opco. While this may be the case where the estate wholly owns Opco, in a standard estate freeze, where only the freeze shares themselves are subject to the deemed disposition, and the growth shares are held by the kids or a family trust and have significant value, it is unlikely that there would be such a transaction**[16]**. However, if the freeze shares constitute a significant portion of the corporation’s overall value and there is a lump sum repayment, this could be a possibility, e.g., because it could be necessary to discontinue the business (to repay the note**[17]**); this may also be an issue if the business had otherwise been in the process of being discontinued, reorganized or wound-up**[18]**.

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[1] An entity is defined to include any company, trust, establishment, foundation, anstalt, partnership, society, association, any charitable body or fund, and any other body or organization of any kind, whether incorporated or not.

[2] Presumably, the CRA means “control of the affairs of a private trust”, defined at the end of the questionnaire. Besides having a majority of voting power, this term is defined to include circumstances in which the individual (alone or together with persons or entities) is able to direct the manner in which the trustee or appointer acts; the trustee or appointer or its governing body is accustomed, or is reasonably likely to act in accordance with the individual’s wishes or instructions; it is reasonably likely that upon the individual’s request or suggestion, a nominated person or entity would be appointed to the governing body of the appointer or trustee, or would be added to the class of objects of a power of appointment; or it is reasonably likely that upon individual’s request or suggestion, a power in respect of the trust would be exercised so that an interest in the capital or income of the trust would be vested. . . in a nominated person or entity.

Obviously, answering these questions in the affirmative could have significant ramifications as to the efficacy of the trust itself.

[3] A questionnaire I saw a couple of years ago is much more concise and asks for some of the same information, but this one seeks details on asset composition (for example).

[4] 2008 CanLII 53123, OSC.

[5] If, at the testator’s death, the specific property is not found among the testator’s assets, the gift is considered to fail or “adeem”. This can happen because the item is lost, destroyed, sold or given away before the testator dies. If there are proceeds from the disposition of the item, the proceeds fall into residue and are distributed accordingly. Therefore, the proceeds are not given to the named beneficiary.

[6] Having so found, the court had to deal with a bequest to another grandchild which was much less broadly worded. In this case, the wording was “rectified” by the court to accord with the broader meaning of the first bequest. To do otherwise would have jeopardized testator’s intention of a roughly equal split of corporate and real estate assets between the two sets of children. The court indicated:

> “Were I to hold otherwise and find that the gift of the [second property] failed, I have no doubt that John Kaptyn would be waiting, with a host of other dissatisfied testators, on the other bank of the River Styx, ready to give me an earful when I arrived. That is a confrontation I wish to avoid.” [Paragraph of 156]

[7] If the shares of Holdco held by the estate were simply redeemed directly, there would be a deemed dividend and offsetting capital loss.

[8] “Post-Mortem Pipeline Planning”, *Tax Hyperion*, August 2007 (Vol. 7, No. 8), Carswell.

[9] The CRA cited Technical Interpretation No. 2006-0170641E5, as well as Advanced Rulings 2002-0154223 and 2005-014211R3; all three documents are substantially in French.

[10] Theoretically, at least, it would appear that the provision may potentially apply where there has been a sale of a business and the proceeds are bonused out to owner-managers, since funds have presumably been "distributed or otherwise appropriated" on the winding-up or discontinuance of the business. In Doc. No. 2004-0106951I7 (May 31st, 2005), the CRA expressed the view that subsection 84(2) would be applicable to bonuses paid to non-active shareholders, i.e., so as to deny the deduction for the bonus and tax the distribution as a dividend in the hands of the shareholders.

[11] *RMM Canadian Enterprises Inc. and Equilease Corporation* v. *The Queen*, 97 DTC 302 (TCC).

[12] And section 212.1.

[13] 97 DTC 111 (TCC).

[14]On the basis that the funds received by the vendors belonged to the purchaser corporation (by virtue of a temporary borrowing to finance the purchase price), rather than the target itself.

GAAR applied in both cases.

[15] A few of the more notable cases involving subsection 84(2) and its predecessors include *Merritt* (1941), 2 DTC 513 (Ex. Ct.); *Smythe,* 69 DTC 5361 (SCC); *Geransky*, 2001 DTC 243, (TCC); *McMullen*, 2007 DTC 286 (TCC); and most recently *Tremblay et al*, 2009 DTC 1204 (TCC) dealing with "tuck-under" arrangements, which summarizes a number of earlier cases.

[16] In *Merritt* (*supra),* it was indicated that the words "winding-up, discontinuance or reorganization", is a commercial and not a legal term, and even as a commercial term has no definite meanings. In construing these words, one must look to the substance and form of what was done. The words refer to a business, rather than the corporation itself. For a discussion of a number of cases involving the meaning of the word "reorganization" in this context, see "Public Company Non-butterfly Spinouts", Suarez and Ahmed, 2003 CR p.32 20/21 *et seq*.

[17] Although a corporation is presumed to carry on a business, it is possible that this would not be the case to begin with. In fact, in the APFF Round Table Question itself, the hypothetical situation involved a corporation holding only cash; the CRA observed that the company did not appear to be carrying on business.

[18] E.g., because of the advanced age of freezor. Note that there is no "series of transaction" concept in subsection 84(2).