The Capital Gains Exemption: Keeping it Pure

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With the passage of Bill C-28 into law on December 24, 2007 it is now official that the lifetime capital gains exemption in section 110.6 of the *Income Tax Act* (Canada) ("Act")**[1]** has been increased to $750,000 from $500,000. It is anticipated that this change will cause advisors to re-examine strategies that are intended to help their clients make the most out of the exemption. In this regard, even where no sale is remotely contemplated, ongoing planning may be required to ensure that non-qualifying or "offside" assets can be systematically removed from Canadian controlled private corporations carrying on active businesses primarily in Canada to "purify" them so that personally held shares will be able to qualify for capital gains exemption treatment at the time of an eventual sale.

For example, certain corporations just have a knack for spinning off excess cash. This happy problem will surely be made "worse", due to the new eligible dividend rules that encourage corporations to maintain excess cash that they might otherwise have bonused out to get down to the small business limit. As a result, without proper planning, these corporations may over time have more offside assets than assets used by the corporations in their active businesses carried on in Canada and would go offside the 50% test, which must be met for 24 months continuously for the shares to qualify.**[2]**

In other circumstances, ongoing planning will be necessary since where even a single holding corporation is added into a corporate structure the 50% test will generally be upgraded to an "all or substantially all" test, which is often referred to as a 90% test, for the entire 24 month holding period.**[3]**

Also, where an estate freeze has been implemented to multiply the capital gains exemption among "designated persons",**[4]** such as spouses and minor children, then in order to be able to rely on the exception to the subsection 74.4(2) "corporate attribution" rules for corporations that are at all times "small business corporations",**[5]** the corporation will need to satisfy the 90% test at all times. For any period of time where the corporation is not a small business corporation, these rules will deem an individual who has transferred or loaned property to a corporation when one of the main purposes of the transfer or loan can be considered to have been to benefit a designated person to have a deemed interest inclusion based on the value of the transfer or loan outstanding from time to time, less specified amounts. It is worth noting that the application of the subsection 74.4(2) attribution rules will not necessarily mean that the shares will cease to be qualified small business corporation shares unless the 90% test must be met at all times such as may be the case where an individual holds shares of a holding corporation rather than directly in the operating corporation.

Crystallization

Another area that will surely get more attention is transactions implemented to crystallize a shareholder's unused capital gains exemption. However, provided that appropriate ongoing purification strategies are put in place, crystallization may not always be advisable, particularly when the shareholders are young and entrepreneurial. For example, if the shareholder crystallizes his or her exemption and then ends up selling shares of another corporation or ends up selling assets instead of shares**[6]** the shareholder will not be able to enjoy the benefit until he or she dies. In addition, minimum tax, potential blockage of ABILs, the possibility of additional future increases in the amount of exemption or of accidental redemption or repurchase of purified shares and the inherent section 84.1 issues that will be relevant whenever crystallization transactions are implemented must also be kept in mind.

On the other hand, although purification strategies sound great, if the appropriate ongoing maintenance is not properly kept up then shares that currently would qualify for the capital gains exemption might not be able to qualify at a later time when the exemption is to actually be realized on a sale. Worse still, in some situations failure to keep up maintenance may result in the application of the corporate attribution rules.**[7]**

Ongoing Purification Strategies

Even though there are a number of ways to implement ongoing purification strategies, throughout the remainder of this article a mere four strategies will be discussed. For purposes of this article the four strategies discussed will be referred as: the Ongoing Strip Strategy, the Simple Redemption Strategy, the Neuman Strip Strategy; and the Corporate Beneficiary Strategy

What is common among each strategy is that they all require stripping offside assets of an operating corporation ("Opco") into a holding corporation ("Holdco") on an ongoing basis. Provided such strategies are implemented as long-term strategies, until recently it was generally believed that subsection 55(2) should not be applicable to these strategies.**[8]** As a result, unlike presale purification strategies, the ability to remove offside assets is generally not limited to safe income attributable to shares held by Holdco.**[9]** However, due to recent expansive court decisions such as in *Copthorne*,**[10]** which have given the phrase "series of transactions" an almost unlimited scope, tax advisors should still carefully review and weigh the risks with their clients of implementing even long-term strategies that involve the creation of inter-corporate dividends that exceed safe income.

In addition, each of the strategies can be a bit awkward to maintain since the strategies all require a significant amount of maintenance to keep the Opco free of offside assets that might otherwise jeopardize the ability of its shareholders to enjoy their capital gains exemptions at the time of an eventual sale. One practical method that can be use to try to ensure that offside assets will not build up in an Opco is to give instructions to the Opco's banker to automatically transfer cash in excess of agreed amounts to the Holdco as loans to the Holdco. At regular intervals throughout the course of each year the Opco would declare and pay dividends to eliminate any loans owing by Holdco. However, where it is intended that the dividends will qualify as eligible dividends, it will be necessary to comply with the CRA's administrative policies regarding the timing and method of paying such dividends.

Ongoing Strip Strategy

The Ongoing Strip Strategy is basically a safe-income strip strategy that builds in the flexibility to pay inter-corporate dividends that exceed safe income.

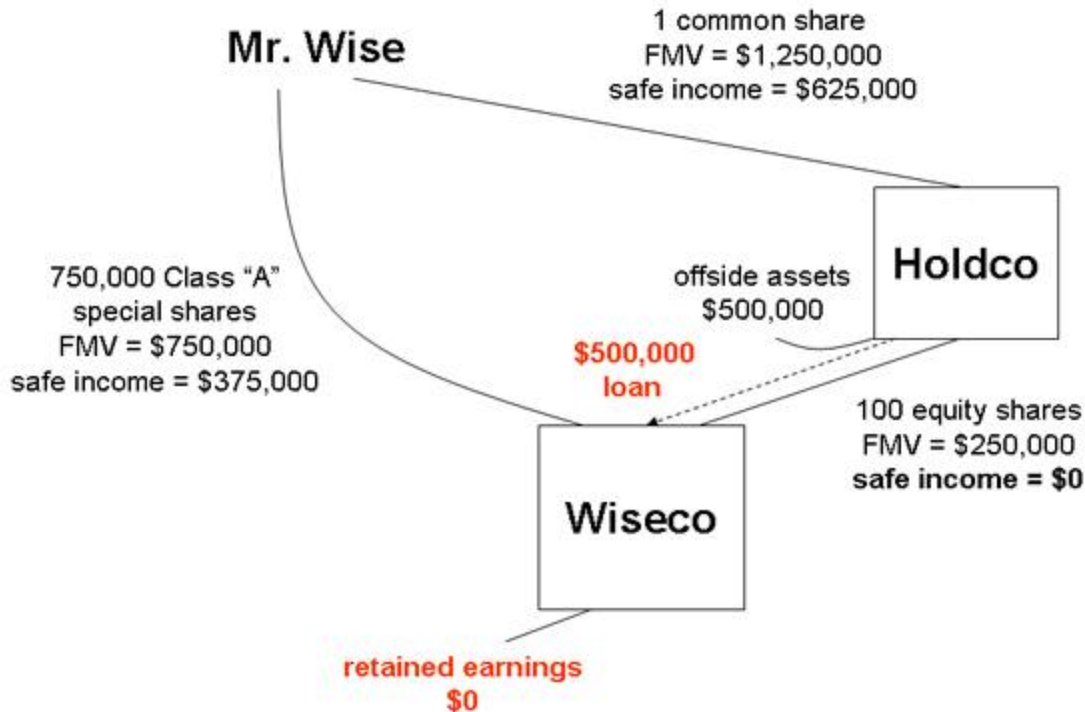
To illustrate the implementation of this strategy, assume that Mr. Wise is the sole shareholder of the 100 issued common shares of Opco worth $2,000,000. Opco has $1,000,000 of retained earnings and $500,000 of offside assets that Mr. Wise wants to strip. Mr. Wise wants to be able to strip additional offside assets from time to time as they build up in Opco.

Mr. Wise will implement a section 86 freeze of his shares whereby he will exchange his common shares under section 86 for 750,000 Class A special shares of Opco, each of which is an ordinary non-voting preference share redeemable and retractable for $1 and 100 equity shares, which are just a new class of common type shares, having a value equal to the remaining $1,250,000 of value of Opco. Mr. Wise will incorporate Holdco and transfer his 100 equity shares of Opco to Holdco on a tax-deferred basis in exchange for common shares of Holdco. Opco could pay a dividend to Holdco equal to the amount of the offside assets, or alternatively it could pay a dividend or series of dividends that exceeds the amount of the current offside assets.**[11]**

From a business perspective paying dividends in excess of the offside assets and lending back amounts that are still required to operate Opco's active business on a secured basis could provide considerable asset protection benefits. Business issues, such as financial covenants, might restrict the ability to proceed in this fashion though there may be ways to deal with such issues. For purposes of this example it is assumed that a $1,000,000 dividend will be declared and that the $500,000 of dividends not represented by off-side assets will be paid by issuance of demand non-interest bearing promissory note.

The diagram below illustrates the corporate structure of Mr. Wise's group after the Ongoing Strip Strategy has been fully implemented.

Ongoing Strip Strategy Example



Mr. Wise might use the Ongoing Strip Strategy to keep Opco "pure" on a perpetual basis because it is relatively simple to implement and does not require a valuation. This strategy might also be attractive if he doesn't want to commit to crystallize his exemption on the Opco shares at the present time - for example, because he owns other corporate shares that he might sell first.

On the other hand, there are some issues to keep in mind when implementing the Ongoing Strip Strategy. For example, in addition to the subsection 55(2) issue discussed previously, the usual issues relating to ensuring that Opco will be considered to be "connected"**[12]** with Holdco must be kept in mind; otherwise Part IV tax could be levied. If inter-corporate dividends are paid that exceed the safe income in the shares other issues, including GAAR, may also need to be considered, especially if there is an eventual sale of the shares of Opco. In addition, this strategy would not enable Mr. Wise to utilize his full capital gains exemption if his personally held shares he retains in Opco are not worth $750,000 at the time the strategy is implemented. Finally, without further planning, the strategy will not be useful if Mr. Wise is hoping to multiply his capital gains exemption with a freeze in favour of a typical Canadian discretionary family trust.

Simple Redemption Strategy

The Simple Redemption Strategy is a variant of the Ongoing Strip Strategy that would involve Mr. Wise completely freezing his common shares of Opco in exchange for ordinary freeze shares some of which he will transfer to Holdco so that they can be redeemed to remove offside assets from Holdco.

The freeze could be put in place with a family trust acquiring the growth shares of Opco to achieve traditional estate freeze objectives and also enable Mr. Wise to multiply the use of the capital gains exemption among his family members. If the freeze includes his minor children and/or his spouse then care will need to be taken to avoid the application of the corporate attribution rules.**[13]**

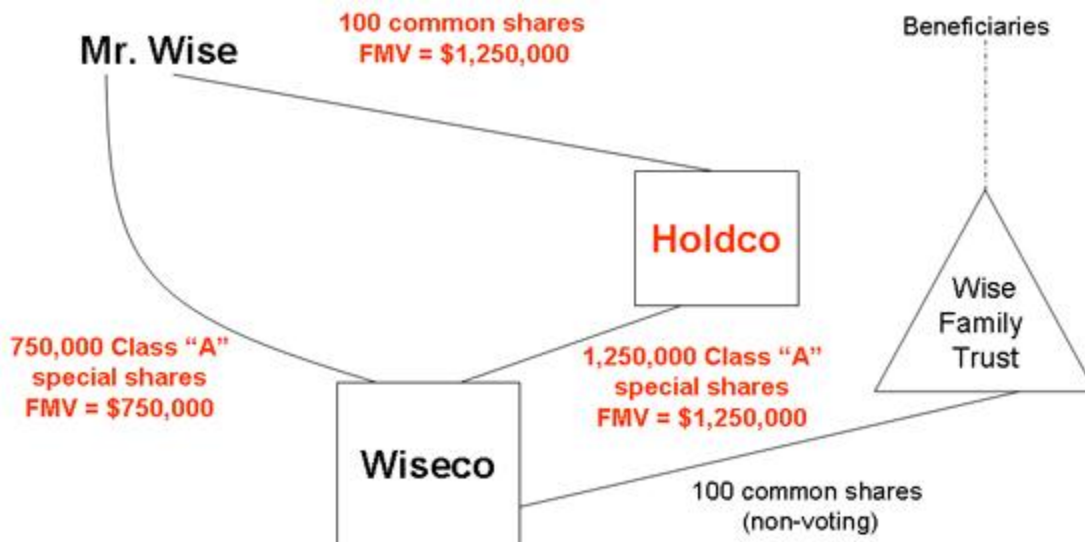
When implementing any type of estate freeze strategy, our practice is generally to ensure that the freeze structure does not impact on corporate control. To maintain control generally the freezor will directly or indirectly hold some class of voting control shares and any trusts or individuals that become shareholders will generally be given shares that either have no votes whatsoever or nominal votes where necessary. Among other benefits, proceeding in this fashion will generally eliminate Part IV tax problems and will also avoid having to deal with the CRA's administrative positions dealing with changes of control and trustees of trusts.**[14]**

The diagram below illustrates the simple redemption strategy based on the assumption that Mr. Wise wants to maintain shares having a value equal to his capital gains exemption, he would transfer $1,250,000 of the frozen

shares to Holdco on a tax deferred basis and would continue to hold $750,000 of the frozen shares. From time to time Holdco could request periodic redemptions of its frozen shares of Opco or if Mr. Wise is more aggressive he might even cause Holdco to have all of the frozen shares redeemed at once.

In order to keep the diagrams illustrating this and the remaining strategies relatively uncluttered, the diagrams will be prepared on the assumption that all of the Class A special shares have been redeemed and all references to the loan back of assets, offside assets and retained earnings amounts will be ignored.

Simple Redemption Strategy Example



In general the tax advantages, risks and issues associated with this strategy are similar to those described in connection with the Ongoing Strip Strategy. However, the subsection 55(2) risks associated with the Simple Redemption Strategy would be heightened since each redemption would normally give rise to a deemed dividend that is at least partially unprotected by safe income and where redemptions are used the subsection 55(2) risks are greater than where simple dividends are paid.

The main non-tax related problem with this strategy is that once all of the Class A special shares are redeemed additional planning will need to be put in place to strip additional offside assets.

Neuman Strategy

In the context of purification, the Neuman Strategy is any strategy whereby a Holdco is introduced as a shareholder of a class of shares that permit dividend sprinkling to Holdco in accordance with the *Neuman* case**[15]** so that a corporation such as Opco can remove offside assets on an ongoing basis in a tax effective manner through inter-corporate dividends.**[16]**

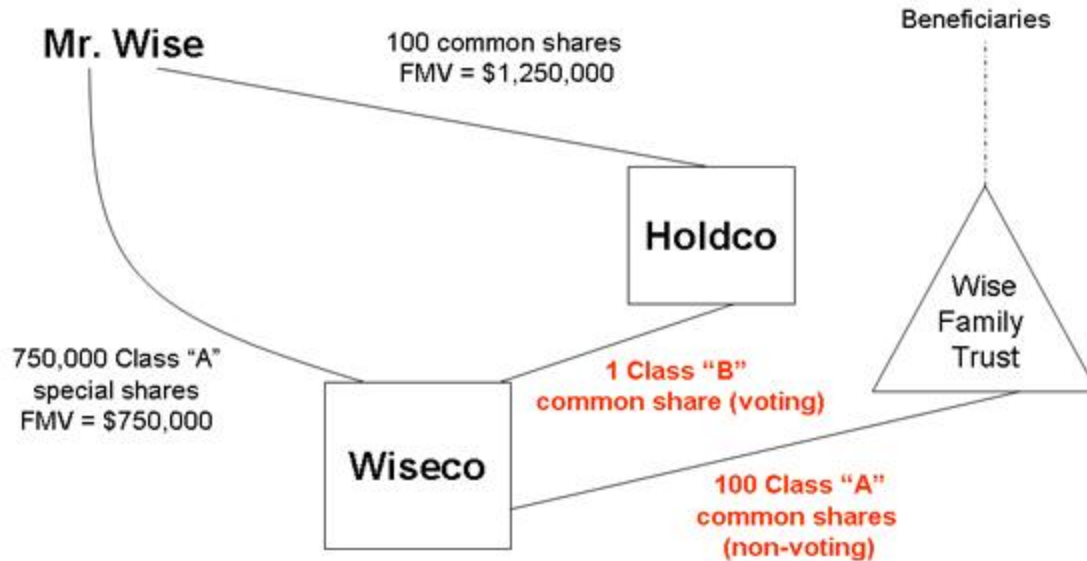
When this strategy is used, our practice would usually be to have the Holdco acquire a nominal number of one class of common shares and, in a freeze situation, for the family trust to own a large number of another class of common shares of the operating corporation so that the lion-share of the growth will accrue to the common shares of the operating corporation owned by the trust.**[17]**

We understand that rather than use common shares some practitioners would have Holdco own shares that are entitled to unlimited dividend rights but no equity participation. To date we have not generally used such shares.

Although some practitioners' approaches might differ, we would generally recommend that steps similar to the simple redemption strategy be used to remove pre-existing offside assets. This is also true for the Corporate Beneficiary Strategy, which will be discussed in later slides.

An example of this strategy is set out in the diagram below.

Neuman Strategy Example



Corporate Beneficiary Strategy

The Corporate Beneficiary Strategy employs a trust with a corporate beneficiary and relies on subsection 104(19) for the ability to strip assets by paying dividends to the trust which are then distributed to the corporate beneficiary without the dividends losing their character as ordinary tax neutral inter-corporate dividends.**[18]**

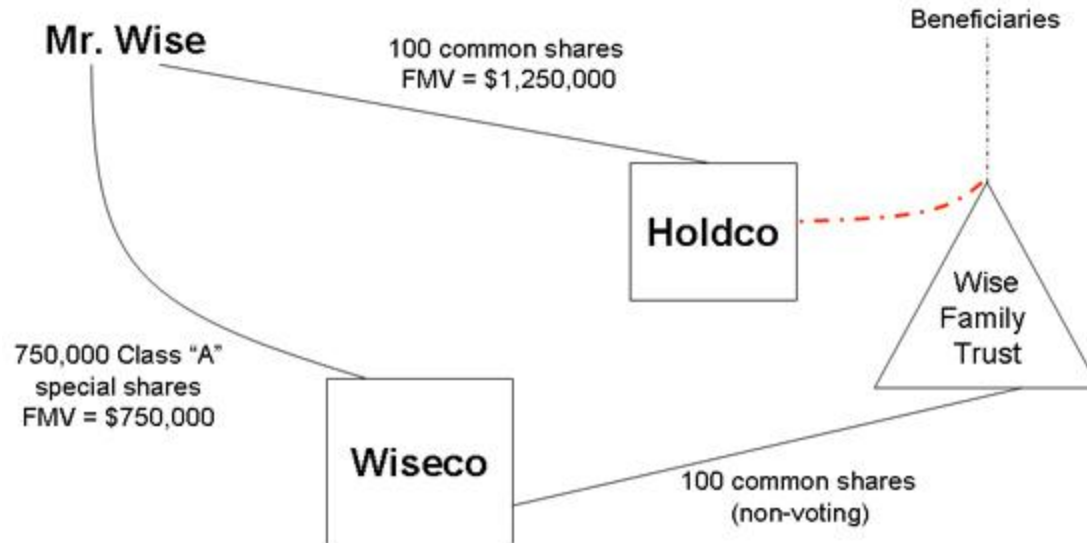
This strategy is an alternative to Neuman Strategies but is arguably less artificial since it relies on the clear provisions of the Act rather than the *Neuman* decision for its ability to effectively pay disproportionate dividends.

Though tax issues involving subsection 55(2) are similar to the risks referred to previously, in more complex corporate structures, the Part IV tax issues might require additional analysis and might effectively preclude the use of this strategy.

Since it has been assumed that Holdco will be frozen in favour of the trust and since Holdco will be a corporate beneficiary of the trust an additional risk of this type of planning is that arguably subsection 75(2) could be applicable.**[19]** In a recent technical interpretation the CRA indicated that where a trust has paid FMV for its shares in a corporate beneficiary it would not apply subsection 75(2). This technical interpretation reversed prior positions taken by the CRA.[xx]

An example of this strategy is set out below.

Corporate Beneficiary Strategy Example



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[1] RSC. 1985, c.1 (5th Supp.), c.1 as amended. Unless otherwise indicated, all statutory references are to the Act.

[2] See paragraph 110.6(1)(c)(i) of the "qualified small business share" definition.

[3] See paragraph 110.6(1)(d) of the "qualified small business share" definition. Although there are cases that have applied a lower standard than 90% to the meaning of "all of substantially all", to the extent possible, the 90% standard should be adhered to when planning to take advantage of the capital gains exemption.

[4] As those terms are defined in subsections 74.4(1) and 74.5(5).

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

[6] In the case of an asset sale purification will also not be beneficial for capital gains exemption purposes, though due to the asset protection benefits offered by entering into purification strategies it is likely that there will continue to be other benefits of pursuing such strategies.

[7] In the past, some practitioners also expressed the concern that the exemption might be eliminated without grandfathering or lead-time. This risk seems somewhat unlikely at the present time but remains a concern.

[8] If timing is a concern then it would be advisable to try and time the dividend payment towards the end of the dividend paying corporation's fiscal period and to ensure that that corporation's corporate tax return is filed as soon as possible thereafter to attempt to start the limitation period running or that year.

[9] Similarly, the ability to implement other types of planning such as butterfly and spinout transactions should also not be impeded by safe income concerns.

[10] *Copthorne Holdings Ltd. v. The Queen*, 2007 DTC 1230 (TCC).

[11] Although in the examples used in this article we have limited the amount of the dividends to the amount of retained earnings in Opco to avoid creating a deficit, subject to corporate law concerns it might be possible to pay additional dividends.

[12] As that term is defined in subsection 186(4). In particular, the operating corporation must either be controlled by Holdco or Holdco together with other non-arm's length persons (see subsection 186(2)) or Holdco must own greater than 10% of the shares of the operating company having full votes and value of the operating company at all times.

[13] As discussed earlier in this article, provided that Opco is always a small business corporation, the corporate attribution rules in subsection 74.4(2) should not apply where transfers are made for the benefit of designated persons, such as is typical when implementing estate freezes. The introduction of Holdco, a corporation that will not be a small business corporation, as described in this strategy would appear to require a separate analysis of the corporate attribution rules. Fortunately, it appears that the corporate attribution rules would not be applicable as a result of the transfer to Holdco since, per paragraph 74.4(2)(a), the only corporation in which a designated person is a "specified shareholder" (within the meaning of paragraph 74.4(2)(a)) is a small business corporation.

[14] See *Technical Interpretation 2004-0087761E5* dated May 24, 2005.

[15] *Neuman v. M.N.R.*, 98 DTC 6297 (SCC). Very briefly, the case is generally considered to have "validated" dividend splitting using different classes of shares on which discretionary dividends could be declared to the exclusion of other classes.

[16] For more on the Neuman Strategy see Len Vandenberg, "The Capital Gains Deduction - A Checklist Approach," 2000 British Columbia Tax Conference, (Vancouver: Canadian Tax Foundation, 2000), 8:22-23.

[17] Some practitioners are bothered by the artificiality of the Neuman Strategy and strategies similar to the Neuman Strategy. In particular, very large dividends can be paid on a small number of shares with nominal values; also, unless a non-impairment clause is in place, subject to applicable corporate law, there is the potential of using dividends paid on such shares to strip pre-existing equity value.

[18] For more on the Corporate Beneficiary Strategy see Todd M. Rosenberg, CA., LL.B., "Inter-Vivos Trusts," 2004 Prairie Provinces Tax Conference, (Toronto: Canadian Tax Foundation, 2004), 15:21-24 and the Vandenberg article, *Ibid* pages 8:23-24.

[19] It might be possible to avoid this problem by having a different corporation act as the corporate beneficiary. Of course, this will add additional complexity and cost to the strategy.

[20] See *Technical Interpretation 2006-0218501E5* dated March 9, 2007 (French).