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The Economic Statement: Some Comments

I would be remiss if I did not sneak in a few comments about the October 30th Economic Statement, which was released just before our publication deadline.

The reduction of federal corporate tax rates to 15% in 2012, applicable to general-rate business income, is a substantial tax reduction. The following is a summary of the federal corporate tax rate reductions:

	2007	2008	2009	2010	2011	2012
Existing rate	22.12%	20.5%	20.0%	19.0%	18.5%	18.5%
Proposed rate	22.12%	19.5%	19.0%	18.0%	16.5%	15.0%

Notes:

- The 2007 rate of 22.12% includes the 1.12% corporate surtax which will be eliminated in 2008.
- The rate cuts will also apply to the new tax on distributions of income trusts and other specified investment flow-through entities as of 2011.
- All rates herein are based on calendar years.

Although the full impact of the proposals is years off, corporate tax rates are already falling. Using Ontario as an example, the general business-income corporate tax rate, which hovered at just over 36% for a number of years, will drop to 33.5% for calendar 2008, with an additional two-point provincial reduction for M&P income. The rates will continue to drop until they reach 29% in 2012. (Alas, this ignores Ontario's infamous "clawback" tax – I will come back to this in a moment.) In fact, the Economic Statement indicates that the Department of Finance will push for 10% provincial tax rates, which will bring the target rate to 25% in 2012.

This is a far cry from the rate on investment income, which will remain at close to 49% (in Ontario) for the foreseeable future. As a result, there will be increased pressure to convert would-be investment income to that taxable at general business rates (e.g., a would-be specified investment business with more than five full-time employees). Even without the small business deduction, tax deferral on incorporated business income will be substantial, with an eventual deferral of close to 40%[1] in Ontario (again, ignoring the clawback). As corporate tax rates drop, there will also

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be an increasing incentive to defer income, if for no other reason than to pick up the 2.6% reduction that applies between 2007 and 2008.

As I have mentioned in previous articles, the Ontario clawback – a 4.67% hike for income between $400,000 and about $1.1 million – is a substantial deterrent to the retention of profits at the corporate level. When it comes to corporate tax rates, the federal government has gone out of its way to reduce them, but Ontario hasn't lifted a finger for its hard-hit manufacturing sector. While Ontario's general corporate rate on business income is pretty well at the top of the heap (or the bottom, depending on how you look at it), when the clawback is tacked on, provincial rates top out at a heartbreaking 18.67%, in the clawback income zone mentioned above. I am hopeful that Ontario's new Finance Minister will take this opportunity to drop Ontario's corporate tax rate to the targeted 10% – and above all, to trash the clawback (which is ignored from here on).

Another consequence of the corporate rate drop is that there will be a further bias toward eligible capital amounts (e.g., goodwill) rather than capital gains status. The Ontario corporate rate for the latter will be a mere 14.5% by 2012, nearly 10 points lower than the rate for capital gains.

The reduction of the general corporate tax rates, coupled with the phase-in of the eligible dividend regime, will mean that there will generally be a degree of over-integration when income taxed at general business rates is distributed as eligible dividends, with the combined personal-corporate tax rate in Ontario at about 44.9% compared to the top 46.4% personal tax rate. The budget papers mention the possibility of adjustments to the enhanced dividend tax credit.[2] It is hoped that the Department of Finance will be sensitive to possible complexities arising from these changes.

The government did relatively little in terms of small business rates, simply accelerating the .5% reduction – formerly slated to take effect in 2009 – by one year. But it didn't have to do much. With reductions already coming into effect, the small business Ontario rate will drop from 18.62% in 2007 to 16.5% in 2008.

– David Louis, B. Com., J.D., C.A., tax partner, Minden Gross LLP, a member of MERITAS Law Firms Worldwide. Thanks to Michael Goldberg of Minden Gross for some hasty calculations

Notes:

[1] I.e., the Ontario corporate business rate in 2012 will be about 62.5% of the top personal rate.

[2] As well as other tax rules that assume a specific underlying corporate income tax rate.

TAX NOTES

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For CCH Canadian Limited

ROBERT SPENCELEY, Editor
(416) 224-2224, ext. 6279
e-mail: Robert.Spenceley@wolterskluwer.com

ROBIN MACKIE, Director of Editorial
Tax, Accounting and Financial Planning
(416) 228-6135
e-mail: Robin.Mackie@wolterskluwer.com

TR ISLAM, Marketing Manager
(416) 228-6166
e-mail: TR Islam@wolterskluwer.com

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CIRCULATION DEPT.
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TORONTO ON M5W 1A1
email circdept@publisher.com

Draft Legislation Re Remaining 2007 Budget Measures

On October 2, 2007, the Department of Finance released two packages of draft legislation, draft regulations, and explanatory notes. The first package, described in News Release No. 2007-074, contains the legislation, regulations, and notes for the Registered Disability Savings Plan ("RDSP") that was proposed in Resolution 2 of the 2007 federal Budget. The other package, described in News Release No. 2007-075, implements the remaining tax measures contained in the 2007 federal Budget (other than the RDSP proposal and the measures that were implemented by Bill C-52 (Royal Assent June 22, 2007)). The draft legislation, draft regulations, and explanatory notes for these two packages, as well as the accompanying Department of Finance News Releases are posted on CCH Tax PROTOS® and CCH's News Tracker. CCH SPECIAL REPORT No. 029H, containing the above-noted documents, may be ordered by calling the CCH Customer Satisfaction Hotline at (416) 224-2248. Outside the Greater Toronto Area, call toll free at 1-800-268-4522.

Registered Disability Savings Plan – Department of Finance News Release No. 2007-074 sets out that the draft legislation and regulations released on October 2, 2007 implement the rules for RDSPs, and, under the new *Canada Disability Savings Act*, the rules for the Canada Disability Savings Grants and Canada Disability Savings Bonds. Written comments on the legislative proposals could be

sent to the Tax Policy Branch, Department of Finance and the Office of Disability Issues, Human Resources and Social Development Canada at 140 O'Connor Street, Ottawa, ON K1A 0G5, on or before October 23, 2007.

Other Tax Measures from 2007 Budget – Department of Finance News Release No. 2007-075 notes that comments on the draft legislation released on October 2, 2007 relating to the remaining Budget measures were also requested by October 23, 2007. The items covered in this legislative package are described in the list from the News Release that is reproduced below.

* * *

The legislation released today:

- Introduces a new Working Income Tax Benefit.
- Eliminates income tax on elementary and secondary school scholarships.
- Eliminates capital gains tax on donations of publicly-listed securities to private foundations.
- Enhances the child fitness tax credit.
- Expands the scope of the public transit tax credit.
- Increases the lifetime capital gains exemption to $750,000.
- Increases the deductible percentage of meal expenses for long-haul truck drivers.
- Provides tax relief in respect of the 2010 Winter Olympic and Paralympic Games.
- Allows for phased-retirement options for pension plans.
- Extends the mineral exploration tax credit.
- Enhances tax benefits for donations of medicine to the developing world. The Government is also developing a process requiring the certification of charities eligible to receive such donations, including a requirement that the activities of the charity be consistent with World Health Organization guidelines.
- Streamlines the process for prescribed stock exchanges.
- Introduces an investment tax credit for child care spaces.
- Introduces a new withholding tax exemption with respect to certain cross-border interest payments.
- Prevents double deductions of interest expense on borrowed money used to finance foreign affiliates (the Anti-Tax-Haven Initiative).
- Eases tax remittance and filing requirements for small business.
- Increases the percentage of available input tax credits for goods and services tax and harmonized sales tax (GST/HST) paid on meal expenses of long-haul truck drivers.
- Increases the GST/HST annual filing and annual remittance thresholds.
- Increases the GST/HST 48-hour travellers' exemption.
- Introduces a self-assessment rule in respect of intangible personal property acquired on a zero-rated basis and consumed in furthering domestic activities.
- Repeals the excise tax exemptions for renewable fuels, including ethanol and bio-diesel.

The Minister noted that the Anti-Tax-Haven Initiative measures have benefited from the input of an informal roundtable of private sector tax experts. . . .

In addition, draft legislation to implement functional currency reporting, and to provide certain tobacco processors that do not manufacture tobacco products with relief from the Tobacco Manufacturers' Surtax, is being released as part of this package.

* * *

Proposed measures related to the taxation of financial institutions announced on December 28, 2006, will be released in the near future.

* * *

Important Changes Announced to the Canada–U.S. Income Tax Convention[1]

The Fifth Protocol (the "Protocol") to the *Canada–U.S. Tax Convention* (the "Treaty") was signed on September 21, 2007 by the Canadian Minister of Finance and the U.S. Secretary of the Treasury. The Protocol amends the Treaty in several significant ways, and will have an important impact on commerce between the two countries. The key amendments deal with the elimination of the withholding tax on interest, with the extension of Treaty benefits to hybrid entities such as limited liability companies ("LLCs") in certain circumstances and with the denial of Treaty benefits to hybrid entities in certain circumstances. Also significant from a Canadian perspective is the extension of the limitation on benefits provisions to investments into Canada.

Withholding Tax on Interest

As expected, the Protocol eliminates the withholding tax on interest payments, removing a substantial barrier to cross-border financing. Until now, the rate of withholding tax on interest paid by a Canadian resident to a U.S. resident (or *vice versa*) has been reduced to 10% pursuant to the provisions of the Treaty. Under U.S. domestic law, there is an exemption from U.S. withholding tax on portfolio interest paid by a U.S. resident to a foreign lender. In general terms, the portfolio interest exemption applies to interest on loans made by non-U.S. persons, other than banks, provided that the lender owns less than 10% of the share capital of the U.S. borrower. There was no corresponding broadly based exemption from withholding under Canadian domestic law. Instead, term loans made to Canadian corporations could be structured to avoid Canadian withholding provided that the borrower was not required to repay more than 25% of the principal amount of the loan within five years from the time the funds were

advanced, except in the case of a failure or default under the terms of the agreement. However, there were often difficulties with respect to destruction of assets or changes of control. There was no exemption from Canadian withholding tax on interest in respect of revolving loans.

Pursuant to the Protocol, the withholding tax on cross-border interest payments will be eliminated with respect to interest paid to an unrelated person for amounts paid or credited on the first day of the second month that begins after the date the Protocol enters into force. The withholding tax on interest paid to a related person will be phased out, with the rate being reduced to 7% in the first calendar year the Protocol becomes effective, and 4% in the second calendar year, before being totally eliminated thereafter. The change will make it less costly for Canadian borrowers to obtain financing from the United States, eliminating the additional costs that have traditionally been built into such loans by lenders requiring interest payments to be grossed-up to account for the withholding tax. Lenders will also find it easier to compete with their institutional counterparts across the border, leading to a levelling of the playing field between Canadian and U.S. banks. The result should be a freer flow of credit and a general reduction in the costs associated with debt financing.

LLCs and Other Fiscally Transparent Entities

Another major change contained in the Protocol is designed to address the problem of flow-through entities such as LLCs, a popular vehicle used to carry on business in the U.S. Under the Treaty as currently drafted, U.S. LLCs are generally not entitled to the benefits of the Treaty as they do not meet the definition of a resident. A resident is a person who "under the laws of that State is liable to tax therein . . .". Since an LLC is not subject to tax at the entity level, unless it elects to be treated as a corporation for U.S. purposes, it is not a resident of the U.S. for purposes of the Treaty. Canada has refused to look through LLCs since they are regarded as corporations under Canada's domestic law. This has led to major difficulties in structuring investments into Canada by LLCs.

The Protocol will amend the Treaty to extend its application to an amount of income, profit or gain derived through a fiscally transparent entity by persons who are resident in a contracting state from the other state through a fiscally transparent entity. The Treaty will deem a person who is a resident of a contracting state to have received an amount of income, profit or gain directly provided that:

(i) the person is considered under the laws of the country in which they are resident to have derived the amount through an entity (other than an entity resident in the other country);

(ii) the entity is treated as fiscally transparent by their country of residence; and

(iii) provided that under the taxation law of their country of residence, the treatment of the amount is the same as the treatment such amount would have received had it been earned directly.

This provision will result in a U.S. person who earns Canadian-source income through an LLC receiving the same protection under the Treaty as if they had earned such income directly. This is a welcome change for U.S. investors.

Denial of Treaty Benefits for Certain Hybrids

The Protocol also contains two new rules which may deny Treaty benefits where amounts are earned through or from hybrid entities in certain circumstances. This change will affect certain cross-border financing structures.

The first of these rules provides that an amount of income, profit or gain is not entitled to any benefit under the Treaty, where, (i) under the tax laws of the source country, a person resident in the other country ("home country") is considered to have derived the amount through a fiscally transparent entity that is not a resident of the source country, and (ii) because the home country does not treat the entity as being fiscally transparent, the treatment of the amount under the tax law of the home country differs from what it would have been if the person resident in the home country had received the amount directly. This provision is difficult to interpret; however, it seems that this change will affect transactions where, for example, interest is paid by a corporation resident in Canada to a partnership which elects to be treated as a foreign corporation for U.S. purposes.

The second rule provides that an amount of income, profit or gain is not entitled to any benefit under the Treaty, where, (i) under the tax laws of the source country, a person resident in the home country is considered to have received the amount from an entity which is a resident of the source country, and (ii) because the home country treats the entity as being fiscally transparent, the treatment of the amount under the tax law of the home country differs from what it would be if the entity were not treated as being fiscally transparent. This means that dividends and interest paid by a Canadian resident unlimited liability company ("ULC"), such as a Nova Scotia or Alberta ULC to a U.S. parent will not be entitled to a reduced rate of withholding under the Treaty. It is not clear whether this result was intended. If this provision comes into force as currently drafted, it will have a significant impact on countless U.S. investments into Canada. These rules are not effective until at least 2010.

Limitation on Benefits Provision

The Protocol contains a new limitation on benefits provision which denies the benefits of the Treaty to a resident of a contracting state where, in very general terms either less than 50% of the ownership of the resident (on either a votes or value basis) is held by residents of the contracting state or where more than 50% of the gross income of the resident is paid to persons who are not resident in the contracting state. Unlike the former provision, it will apply to investment in Canada. This marks a

significant change for Canada which has generally not included a limitation of benefits provision in its treaties. Until now, Canada has relied on its general anti-avoidance rule to deal with treaty shopping.

Dividends Received by a Partnership

Another important change is made with respect to the treatment of dividends received by a partnership. Under the Treaty the rate of withholding tax on dividends paid by a contracting state to a resident of the other state is reduced to 5% provided that the recipient is a company which owns a minimum of 10% of the voting stock of the payer corporation, and 15% in all other cases. Canada has taken the position that where a U.S. corporation is a member of a partnership which owns shares of a Canadian corporation, the rate of withholding tax cannot be reduced to 5%, even if the U.S. corporation owns, indirectly through the partnership, more than 10% of the voting stock of the Canadian corporation. The Protocol proposes to remedy this problem by deeming a company to own the voting stock which is owned by a fiscally transparent entity of which it is a member.

Permanent Establishment

Article V (Permanent Establishment) was also amended to provide that an enterprise of one contracting state will be deemed to have a permanent establishment in the other state where:

(i) services are performed by an individual who is present in the other state for 183 days or more in any 12-month period and during that period more than 50% of the gross business revenues of the enterprise are derived from services performed in the other state by the individual; or

(ii) services are provided for 183 days or more in any 12-month period with respect to a project or a connected project for customers who are resident in that other state or with respect to a permanent establishment in that state.

Dual Resident Corporations

The Protocol will amend Article IV, the Residency article, with respect to dual resident corporations. Under corporate law, a corporation incorporated in certain U.S. states or Canadian provinces can be continued into or incorporated under the laws of certain states or provinces of the other country. The Treaty provides that a corporation resident in both Canada and the United States shall be deemed to be a resident of its jurisdiction of incorporation. However, notwithstanding the general rule, where a corporation is resident in both contracting states and is continued into the other state, the Treaty deems it to be resident in the other state while it is so continued to be a resident of the other state. The Protocol will delete the provision dealing with continued corporations. Under the Protocol all dual resident corporations which are created under the laws of one state but not under the laws of the other will be deemed to be resident only in the jurisdiction under the laws of which it was created. In any other case, the competent authority will endeavour to determine its residence. If the competent authority cannot agree, it will be considered to be resident in neither jurisdiction for purposes of the Treaty. This provision of the Protocol will be effective after September 17, 2000.

Taxpayer Migration

Article XIII of the Treaty is amended to remedy a problem that exists under the current law where a person emigrates from Canada to the United States. Under Canada's domestic law where a person emigrates from Canada, the person is deemed to have disposed of most types of property for proceeds equal to their fair market value. The United States did not provide a step-up in the tax basis of the property to the immigrant resulting in double taxation on the subsequent sale of the property. The Protocol provides that where an individual (and not any other type of entity) has been deemed to have alienated property in a taxable transaction in one country, the individual can elect for tax purposes in the other country to be deemed to have acquired the property at its fair market value as at that date.

Stock Option Benefits

The Protocol will also deal with stock option benefits. The Protocol will deem a stock option benefit to be derived from the country in which the person is principally employed during the time the option is held. This change is designed to deal with situations where an employee is granted an option while a resident of one country, but moves to the other prior to the date of exercise. It will apportion the benefit between the two countries for tax purposes.

Mandatory Arbitration

The Protocol will also impose mandatory arbitration on the Canadian and U.S. tax authorities where a dispute cannot be resolved by them. Currently, a resident of either country can ask the competent authority in their country of residence to resolve an issue involving taxation in both jurisdictions. However, if the matter cannot be resolved by the revenue authorities, until the Protocol is effective, there is no further mechanism to resolve the dispute.

Pensions

The Protocol will provide for deductions, in certain circumstances, for contributions to pension plans and certain other retirement arrangements made both by individuals who move between Canada and the United States on short-term assignment and by cross-border commuters. For example, an individual who moves from Canada to the United States on a short-term work assignment (less than five years) and who continues to contribute to the individual's Canadian employer's pension plan, provided that

certain conditions are met, will be able to deduct the individual's contributions for U.S. tax purposes. The U.S. employer of such an individual would also be able to deduct its contributions. In addition, a cross-border commuter, such as a Canadian resident who is employed in the United States, who contributes to a pension plan of the employer, provided certain conditions are met, will be able to deduct such contributions for tax purposes in the employee's home jurisdiction. In the example, the Canadian resident would be able to deduct contributions to the U.S. employer's pension plan for Canadian tax purposes (up to the individual's RRSP deduction limit).

Income from Employment

In line with changes made to the OECD Model Tax Convention in 2000, the new Protocol deletes Article XIV of the Treaty dealing with "Independent Personal Services". Currently, the Treaty contains different rules for business income and for income from independent personal services. The business income of a non-resident is taxed in the source country only to the extent that it is attributable to a "permanent establishment" in the source country, while the income of a non-resident independent contractor or self-employed person is taxed in the source country only to the extent that it is attributable to a "fixed base regularly available to him" in the source country. The Protocol eliminates this distinction, such that income from independent personal services will be treated no differently from any other form of business income. Consequently, the concept of "fixed base" will disappear, and will be replaced by "permanent establishment". As a consequential amendment, Article XV's subtitle will change from "Dependent Personal Services" to "Income from Employment".

Taxes Imposed by Reason of Death

The new Protocol also amends Article XXIX-B of the Treaty dealing with "Taxes Imposed by Reason of Death". Until now, U.S. residents have had access to the spousal rollover for capital property under subsection 70(6) of the *Income Tax Act*, but they have not had access to the spousal rollover for Canadian resource properties or land inventories under subsection 70(5.2). In other words, the Canadian resource properties and land inventories of a Canadian resident could pass to a surviving spouse on a tax-deferred basis, but those of a U.S. resident could not. As a result, a U.S. resident's estate would be required to pay Canadian tax on any accrued but unrealized gains before distributing such property, while a Canadian resident's estate would be able to defer taxation until the surviving spouse's death. The Protocol remedies this discrepancy, allowing U.S. residents to elect rollover treatment and defer the Canadian tax in the same way as a Canadian resident would.

Non-Discrimination Provision

Article XXV of the Treaty (Non-Discrimination) has been broadened. Under the Treaty as drafted, protection of the general non-discrimination rule (which provides that citizens of a contracting state, who are resident in the other contracting state, cannot be subjected to any taxation or requirement which is other or more burdensome than the citizens of the other state) was provided only to citizens of a contracting state. In other words, only individuals could rely on this provision. The Protocol amends this provision to extend to "nationals". A national is an individual possessing the citizenship or nationality of that state and any legal person, partnership or association deriving its status from the laws of that state.

Effective Date

The Protocol comes into force on the later of January 1, 2008 or the date by which both governments have ratified it. However in respect of taxes which are withheld at source, the provisions of the Protocol will be effective for amounts paid or credited on or after the first day of the second month that begins the day after the date on which the Protocol enters into force. In respect of other taxes, except as otherwise specified, for taxable years that begin after (or, if the ratification occurs in 2007, for taxable years that begin in and after) the calendar year the Protocol enters into force.

– Barbara Worndl, Aird & Berlis LLP, Toronto

Notes:

[1] This article first appeared in TAX PROFILE, October 2007. TAX PROFILE is edited by Jack Bernstein and published by CCH.

Wills for the Owner-Manager – Some Special Considerations

This article is based on a section of *Tax and Family Business Succession Planning*, Second Edition, by David Louis and Samantha Prasad, now available from CCH.

The will can play an important role in succession planning, not just as the instrument that details the succession of property between generations, but also as a complement to a shareholders' agreement that may be in place to set out the guidelines and rules by which the corporation should be governed. Accordingly, a will in the context of succession planning should not be overlooked as an additional tool to the management of a corporation after the death of the owner-manager.

Special issues that should be addressed in the will of an owner-manager include the following:

- Does the testator hold thin-voting shares, e.g., shares which carry the right to control the family business; if so, should specific provisions be made in respect to these shares? (Some factors to be considered are discussed in Chapter 2.)

- Will the choice of executor result in association or other tax issues? (See Chapter 8 for further discussion.)

- Are there shareholders' or other agreements in which testamentary designations or elections are to be made? (For example, the shareholders' agreement could provide that certain roles, such as president or directors of a corporation, are to be filled by designation in the owner-manager's will. Additionally, a shareholders' agreement could allow for certain provisions relating to liquidity or profit distribution to be dependent on certain clauses as contained in the will.)

- Is the testator bound by a shareholders' agreement which restricts the manner in which a will can be drafted? As discussed in Chapter 11, a shareholders' agreement could prohibit an outright bequest of shares of the family business to a surviving spouse, restrict the permissible executors/trustees, and may, in the case of a spouse trust, preclude a power to encroach on capital in favour of the surviving spouse in the form of a distribution of shares from the family business.

- Care must be taken that the provisions of the will do not result in associated corporation issues. As discussed in Chapter 8, where beneficiaries' share of income or capital is subject to any discretionary power, each such beneficiary is deemed to own all of the shares held by the trust. Accordingly, care should be taken in respect of discretionary powers. As also mentioned, special rules may apply in the case of a testamentary spouse trust whereby the surviving spouse may be deemed to own the shares in the trust.

- Because the potential imposition of double taxation in respect to bequests of shares of a private corporation is involved, the ability to effect post-mortem reorganizations will be important. Needless to say, the will must provide the executors with the power and authority to cause the estate to effect such reorganizations, which may involve share redemptions/reacquisitions, transfers to holding companies, dissolutions, etc., including elections and designations. As explained in Chapter 12, where a will uses a spouse trust, it is prudent to provide for a lagged distribution on the death of the surviving spouse, rather than calling for an immediate distribution to residual beneficiaries. One of these strategies involves a post-mortem redemption, which tends to trigger deemed dividends and capital losses; the latter can be applied against the capital gain in the spouse trust occasioned by the surviving spouse passing away. Therefore, the spouse trust should be able to continue to hold assets within the normal three-year carryback period.[1]

- If a previous will has made a specific bequest, has the property been subject to a reorganization, so that it is no longer owned directly by the testator?

- Should multiple testamentary trusts be considered?

- Is there indebtedness that should be forgiven in the will? (See Chapter 8 for advantages.)

In addition to the foregoing, a typical "scenario" of a successful business will suggest other issues.

Letters of Wishes

If succession and estate planning have been attended to by the testator, and the family business has been successful, the will may account for only a minority of family assets and, in particular, the value of the family business. If an estate freeze has been carried out, it will typically be the case that much or most of the value of the business is either sequestered in a family trust (typically discretionary) in the form of growth shares, or the shares held by the trust were distributed to beneficiaries prior to its 21st anniversary. If such a distribution has not been made, it will be important that, in addition to the will, the testator provides guidance to the trustees of a discretionary family trust, in the form of a letter of wishes. Otherwise, particularly in view of fiduciary obligations, the trustees may distribute the shares and other trust assets "symmetrically". (Letters of wishes are discussed further in Chapter 8.)

Freeze Shares/Credit Balances

If there has been a freeze of a successful business, the assets of the testator may often consist primarily of the freeze shares themselves, the family home, a vacation property, and RRSPs or other deferred income plans. In addition, there may be liquid assets and "credit balances" of the frozen corporation(s) (i.e., amounts owing to shareholders), especially if the incorporated business has followed the practice of bonusing down to the small business limit, with excess cash (not needed for personal and living expenses) either retained or lent back to the corporation. (If the corporation's income has been within the small business limit, such credit balances may not exist and liquid assets could be locked into the corporation because of the high-tax cost of distributing funds not required for personal use.[2]) Thus, freeze shares and/or credit balances may be at least partly liquid in the sense that they can tap into corporate assets as a "call" on funds and other liquid assets built up in the corporate system over the years.

But while both freeze shares and credit balances will be liquid in this sense, credit balances will be "tax-paid" and can be left to the next generation without triggering a deferred tax liability. The freeze shares, on the other hand, will typically have a low cost base but significant value; accordingly, it will be very important to postpone the recognition of deferred tax on the freeze shares, especially if there are insufficient insurance proceeds or other liquid assets to defray the tax exposure. This will typically involve the use of a spouse trust, one reason being that, while also achieving the deferral, an outright bequest will leave the surviving spouse with the power to bequeath the freeze shares as he or she sees fit, e.g., if the surviving spouse were to remarry (see Chapter 8 for further discussion).

If, on distribution from a family trust or otherwise, the ownership of growth shares has been "skewed" to certain family members – presumably because they will be involved in taking over the family business – the freezer will

often want his or her estate to be used to equalize other family members. If freeze shares pass to beneficiaries, it should, of course, be remembered that, by their nature, they will be retractable – i.e., redeemable by the holder. Accordingly, restrictions on retraction should be addressed, perhaps in a family shareholders' agreement, as discussed in Chapter 11. If the estate is to continue to hold the shares, i.e., in one or more testamentary trusts, the will itself might provide guidance to the trustees.

Business v. Non-Business Assets

In some cases, a testator will wish to leave "business assets" to some family members and non-business assets to others. If so, the will drafter should become knowledgeable in the particulars of the testator's corporate structure, as the testator will probably have corporate assets in mind, as well as personally held assets. In addition, thought should be given to whether post-mortem reorganizations will be required to meet this objective and whether they can be achieved in a tax-effective manner. Also, the meaning of "non-business assets" should be explored and specified in the will, one example being real estate used in the family business.

Notes:

[1] Also, as pointed out in Chapter 12, special provisions might be inserted in a spouse trust in order to facilitate a paragraph 88(1)(*d*) "bump", per the requirements of paragraph 88(1)(*d*.3).

[2] A similar lock-in effect may occur because of recent decreases in corporate tax rates and the eligible dividend regime. See Chapter 2 for further discussion.

Death of a Partner

Where an individual who is a member of a partnership dies and the partnership continues to exist after the individual's death, the individual's income from the partnership for the year of death, which is allocated at the end of the fiscal period of the partnership, is considered to be a right or thing. Where the partnership has a loss, it may be claimed on the decedent's regular return (see Interpretation Bulletin IT-278R2).

Canadian exploration expenses ("CEE") or Canadian development expenses ("CDE") incurred by the partnership are allocated to the members of the partnership at the end of the partnership's fiscal period. The allocated amounts are added to the partner's resource pools pursuant to paragraph (*h*) of the definition of CEE in subsection 66.1(6) and paragraph (*f*) of the definition of CDE in subsection 66.2(5). There would be no allocation; however, where the partner is deceased, as the individual would not be a member of the partnership at the end of the year.

See, however, WINDOW ON CANADIAN TAX ¶8954, where the decedent's estate is a member of the partnership at the end of the partnership's fiscal period.

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CCH Canadian Limited
300-90 Sheppard Avenue East
Toronto ON M2N 6X1
416 224 2248 • 1 800 268 4522 tel
416 224 2243 • 1 800 461 4131 fax
www.cch.ca