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# Valuation and Family-Business Share Structures – Some Musings

Last month, I wrote about the so-called "Vancouver Control Premium" tax file,[1] where the CRA is attempting to assert that there is additional death tax exposure based on a control premium, apparently retained as part of an estate freeze.[2] Just before publication, the CRA indicated that, in respect of voting-non-participating shares of a private corporation (i.e., "thin-voting shares"): "a hypothetical purchaser would be willing to pay some amount for the voting control of a company." (For details, see "CRA Statement on Control Premium" below.)

This issue is receiving a great deal of interest because it directly impacts on standard estate planning structures for family businesses. Our Meritas Tax Group recently had the benefit of input on this topic from two of Canada's leading valuators in this area.

Based on these discussions (and as I indicated in my last article), it appears that even if a family member has only "thin-voting shares" – that is, shares which have virtually no rights other than to vote, a control premium may be applicable (stemming from the controlling shareholder's ability to control the business, pay bonuses, and so on).[3] but probably not nearly as high as is apparently being asserted by the CRA in the Vancouver file.[4]

## Effect of Freeze Shares

But how do other share attributes affect the value of voting rights? Notably, in a family-held business, freeze shares may often be present – that is, shares that are retractable (as well as redeemable), usually with rights to non-cumulative dividends not in excess of a reasonable amount at the time of the freeze.

## Inside

Arguably, at least, the presence of freeze share features may depress the value of a control premium in respect of thin-voting shares, because of the fact that, at the inception of the freeze at least, the retraction rights will give the holder effective control over the company. (It seems to me that this is supported by the CRA's own statements pertaining to the *de facto* control provisions in subsection 256(5.1).)[5]

As the company continues to grow in value, the clout of freeze shares will diminish. Be that as it may, my personal feeling is that, even if the company has appreciated in value fairly substantially, the potential exercise of retraction rights could (theoretically at least) continue to have a great deal of influence on the business, and therefore the value of voting control, especially if the corporation does not have sufficient liquid assets which could readily be used to retire the freeze shares.[6] As most freeze shares are retractable on relatively short notice, it could be asserted that, especially in the present financial environment, it could be quite difficult to obtain the requisite financing to retire the shares on short notice.[7]

While the foregoing factors might militate against a significant value being attributed to a control premium, a broader issue where freeze structures are implemented may be the policy rationale for undermining what has traditionally been regarded as legitimate succession planning for owner-managers and their families.

**TAX NOTES**

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## Exclusionary Dividend Shares

While freeze shares might depress the value of a control premium, the issue may become more serious where the voting shareholder also has rights to strip the company, as would be the case with so-called "exclusionary dividend shares". These are shares which allow shareholders of a class to participate in dividends to the exclusion of the holders of other classes of shares. Typically, one shareholder retains a voting class of exclusionary dividend shares, with non-voting exclusionary dividend shares held by other members of the family.

These shares are often used to preserve control in the hands of the founder of the family business, while maintaining the ability to sprinkle dividends to low-bracket family shareholders. For example, in a start-up situation, the entrepreneur could be given voting exclusionary dividend shares, with non-voting shares issued for a nominal amount to a spouse or family trust. There must be hundreds (thousands?) of these structures out there, in many cases put together to maximize flexibility, often without much thought to valuation issues. (Another common use for such shares is in structures which purify the company as a small business corporation, so that capital gains exemptions will be available).[8] In this case, the valuation issue may not be centered around death tax: a high value attributable to voting exclusionary dividend shares can play havoc with capital gains exemption multiplication, e.g., if the family business is sold.

At least one CRA valuator has pointed out inconsistencies in positions taken by taxpayers. For some structures, such as capital gains multiplication, taxpayers take the position that non-voting exclusionary dividend shares have a high value; whereas, for others, particularly dividend-splitting structures, such shares are asserted to have a nominal value. The CRA valuator believes that the latter is the correct position.[9]

In *Winram Estate v. M.N.R.*[10] (a case pertaining to estate tax) the deceased's shares carried sufficient votes to control the company, and the articles provided for "exclusionary dividends". The deceased held 9 of the 10 voting shares, and 990 non-voting shares were held by the deceased's widow. The Court found that the deceased had the ability to extract the entire surplus of the company as a dividend on the voting shares, without the consent of his wife. Accordingly, 90% of the value of the company was attributed to the deceased by virtue of his voting shares, and the 990 non-voting shares were ignored.[11]

It remains to be seen how aggressively the CRA will challenge situations (such as multiplying the capital gains exemption) where non-voting exclusionary dividend shares are asserted to have a high value.[12] However, discussions with our valuator colleagues confirm that the possibility of a very low valuation for non-voting exclusionary dividend shares is a serious issue.[13] Where such structures

are in play, a more careful review may be in order. While the recent CRA statement on control premium does not specifically deal with exclusionary dividend shares, it serves notice to tax advisors that, in general, the control premium issue must be reconsidered.

*– David Louis, J.D., C.A., Minden Gross, Toronto, a member of MERITAS law firms worldwide. Thanks to Guy Dubé and Bill Cooper (of MERITAS firms BCF and Boughton in Montreal and Vancouver). Special thanks (in alphabetical order) to Vern Blair and Richard Wise.*

**Notes:**

[1] "Suddenly This Summer: Selected Tax Developments", *Tax Notes* No. 548, September 2008.

[2] In fact, fairly recently, there have been at least three major presentations covering this issue: "Valuation – Allocation of Value", Vern Blair, 2007 BCC p. 9:1; "Valuation and Tax Issues", D. Jeffery Harder, 2004 BCC p. 20:1; and "Valuation Issues Relating to Shares of Private Corporations", Richard Wise, 2004 CR p. 13:1. It is not surprising that two out of three papers were penned by British Columbia practitioners. Much of the initiative for control premiums seems to be coming from that neck of the woods.

[3] The "special value" of such shares in respect of non-voting participating shareholders may also be relevant.

[4] Perhaps 15% would be a high number.

[5] See, for example, Interpretation Bulletin IT-64R4, paragraph 23(b). Note also that the liquidation value of a corporation's assets may be less than the retraction amount due to deferred tax exposure.

[6] I submit that it would be disingenuous for the CRA to disagree with this position (assuming that is possible for the CRA to be disingenuous). In paragraph 23 of Interpretation Bulletin IT-64R4, it is stated that *de facto* control depends on each factual situation and that a "substantial" investment in retractable preferred shares could be indicative of *de facto* control. Consider also the effect of a standard non-impairment clause – that dividends or other distributions cannot occur if they would impair the ability to redeem the freeze shares. As the redemption amount will often reflect goodwill at the time of the freeze, freezor might assert that there must be an increase in the value of goodwill or other assets before distributions could be made to other shareholders.

[7] A counter-argument to the effective control of retractable shares could be based on the enforceability of the retraction rights. The directors of the corporation might resist retraction on various grounds. Recent cases in which the rights of such shareholders have cropped-up include *Itak International Corp. v. CPI Plastics Group Limited and Peter Clark*, 2006 CanLII 22117 (ON S.C.); and *Heesh v. Baker* [2008] NSWSC 711. These cases indicate that retractable shares should not be treated as equivalent to debt. Retraction might be resisted on the grounds of corporate solvency test. In *Itak*, where the corporation's Articles envisioned a corporation not being permitted to redeem by virtue of insolvency or other provisions of applicable law "or otherwise", the failure to redeem the retractable preferred shares was nonetheless oppressive to the preferred shareholders in spite of arguments based on the business judgment rule, because, in the particular circumstances, the business judgment of the directors lacked the touchstone of an informed reasoned judgment.

[8] In non-start-up situations, careful consideration should be given to the attributes of such shares, in order to support a nominal value.

[9] Mr. Dennis Turnbull, in various presentations; see Harder, op cit., p. 20:3. One of the basic issues pertaining to control premiums relates to the "family control" concept – that is, the premise is that family members will act together to maximize their mutual wealth, including in respect of the sale of shares of a family business, so that minority discounts should not apply to particular members. However, the CRA has indicated that family control does not apply to allocations between classes of shares – so that the CRA is open to take the position that virtually no value is attributable to non-voting exclusionary dividend shares.

[10] 72 DTC 6187, (FCTD).

[11] However, an opposite conclusion was reached in *Shepp v. The Queen*, 99 DTC 510, (TCC). For a discussion of *Shepp* and other cases in which control premiums and the family control concept have been in issue, see Harder, op. cit., p. 20:9. A recent case in which somewhat similar concepts are involved is *Laflamme v. The Queen*, 2008 TCC 255, in which a family trust held growth shares, but father held shares with conversion rights to these shares sufficient to flood out the family trust's holdings to a nominal amount. The court ignored the conversion rights in determining the fair market value of the growth shares, noting that the exercise would be inconsistent with father's estate planning objectives, the rights were not in fact exercised, and that a buyer of the growth shares would have insisted on a waiver of the rights, which father would have willingly given.

[12] As I mentioned last month, there are indications that, in the Vancouver area, the CRA may also be taking a particularly aggressive stand in respect of an actual tax file involving exclusionary dividend shares. However, it may be too early to tell how serious the CRA is.

[13] Of course, one issue as to the value of non-voting exclusionary dividend shares is the argument that minority shareholder remedies may apply if the voting shareholder attempted to strip the company, particularly in view of *Re Mann Estate* ([1972] 5 W.W.R. 23(B.C.S.C.), aff'd. [1974] 2 WWR 574 (S.C.C.)), and other cases. In the context of exclusionary dividend shares at least, I am skeptical as to whether minority shareholder remedies should dramatically affect valuation (presumably this would be the CRA's view as well). It has also been pointed out that the more recent *McClurg* and *Neuman* cases (91 DTC 5001; 98 DTC 6297; S.C.C.) suggest that a holder of non-voting shares cannot claim *pro rata* value for minority interest based on having legitimate expectations of dividends because of being in a position to apply for an oppression remedy (see "Valuations and Price-Adjustment Clause", R. Wise, 98 CR p. 33:11). One CRA valuator has asserted that where non-voting shareholders have paid a nominal amount for their shares, and the rationale for the exclusionary dividend share structure is tax-motivated, the non-voting shareholder would not have a "reasonable expectation" (per the oppression remedy) of receiving substantial dividends. However, oppression cases themselves indicate that, although the fact a shareholder may have acquired his or her shares as a gift could be relevant to the determination of the "reasonable expectations" of the shareholder, it does not deprive that shareholder of the protection of the oppression remedy or the duties owed to shareholders generally by directors; expectations are not static and may change over time. While *Mann Estate* and other cases may show that the possibility of oppression actions should be taken into account in determining the valuation of shares, the valuators I have spoken with seem to agree that the oppression remedy may have limited scope in respect of sustaining a dramatically higher valuation in this context, because of the trouble and expense of bringing these to court, and the fact that the outcome on this type of situation is questionable. There appears little in the way of guidance offered by existing Canadian (non-tax) case law on exclusionary dividend share situations; it may be the case that the protection afforded to holders of non-voting exclusionary dividend shares would be largely fact driven. However, because of the importance of the oppression remedy in the United States, and the fact that Canadian courts often look to US jurisprudence, it may be that the oppression remedy could become a greater factor in the future. What about the rights of non-voting shares to participate *pari pasu* on a winding-up of the corporation? Again, similar reasoning may apply. Until a wind-up, the voting shareholder would have the ability to strip the company. A non-voting shareholder can go to court for a winding-up order under the OBCA on the grounds that there is oppressive conduct or that a winding-up would be "just and equitable"; however, query whether this prospect would be of material value to a "willing buyer".

# CRA Statement on Control Premium

Some days ago, the CRA released the 2007 CRA Round Table questions (Papers 5 and 6 in English and French respectively[1]). Toward the end of the Paper there are a number of questions indicating that they were "not presented at the 2007 Annual Conference". One of these indicates that the CRA is of the view that a control premium of "some amount" – which depends on the particular facts – is applicable in respect of voting non-participating shares of a private company.

The question and answer are reproduced below.

*– David Louis, Minden Gross LLP*

### Value of Company Attributable to Voting Non-Participating Shares

#### Question

What is the CRA's position on the value of a private company that is attributable to voting non-participating shares?

#### Response

The CRA does not have an established position on valuing different types of property. Information Circular 89-3,[2] outlines the valuation principles and policies that the CRA generally considers and follows in the valuation of securities and intangible property of closely held corporations for income tax purposes. IC 89-3 discusses, in general terms, the approaches applicable to closely held or private corporations, recognizing that the facts and circumstances of each case will be determinative of fair market value. The valuator must use reasonable judgment and objectivity in the selection and analysis of the relevant facts of each case.

For the above-noted reasons, it is not the intention of the CRA to write a policy or state a formal position regarding this issue.

When we value different classes of shares in a company, we generally determine the "en bloc" fair market value and then allocate the value to each class in isolation. The fair market value of each class of shares must be determined on its own merits according to the individual rights and restrictions of each class. In other words, we consider what a hypothetical arm's-length purchaser would be willing to pay for a particular class of shares based on the rights, restrictions, and conditions, which ultimately affect the economic benefits to be derived from ownership. Given the above, there may be many factors which might influence the value of voting control.

We are not aware of any case law that deals specifically with the allocation of value among various classes of shares where voting rights were separated from participation.[3]

**It is the opinion of the CRA that a hypothetical purchaser would be willing to pay some amount for the voting control of a company.** It is difficult to ascertain what a pure voting right would be worth. However, the answer to this question will depend upon the facts and circumstances of each case.

**Notes:**

[1] "Canada Revenue Agency Round Table", 2007 Canadian Tax Foundation Conference.

[2] Information Circular 89-3, "Policy Statement on Business Equity Valuations", August 25, 1989.

[3] [Note from David Louis] Arguably, *Mann Estate* ([1972] 5 WWR 23(BC SC), aff'd. [1974] 2 WWR 574 (S.C.C.)) is relevant, since the shares in question in *Mann Estate* were little more than thin-voting shares. The British Columbia government effectively asserted a control premium well in excess of 1/2 of the value of the company ($81,000 compared to a total value of just under $150,000), based on the present value of salary/administrative fees that could be paid to the shareholder. The court disregarded a somewhat lower valuation offered in court ("at least" $50,000 – based on structural changes that could be made because of voting control), because it ignored applicable corporate remedies for minority shareholders. Instead, the court accepted the evidence of the appellant (a value of only about $1,500, based the shares' 1% participation on breakup). The finding itself disregards control premium; but it may be the case that the lower court's finding was fact-driven and rejected an approach that would have given an unduly large premium to voting rights because remedies for minority shareholders were simply ignored. (At paragraph 19, the court indicates that oppression remedies would "materially reduce any estimate of value".) In essence, *Mann Estate* rejected a control premium of 1/3 of value for (essentially) thin voting shares. A control premium was also rejected in *Fiddes Estate* (70 DTC 1117, TAB), where the voting shares carried the right to about 1% of dividends and assets on liquidation.

# CRA Questions and Answers Re Tax-Free Savings Accounts

The CRA has posted a series of questions and answers for issuers of tax-free savings accounts ("TFSAs"), some of which are also of interest to holders of these plans. The full set of questions and answers is reproduced on CCH online and DVD under Canadian Tax Reporter Commentary/CRA Publications/Registered Plans/Frequently Asked Questions. An excerpt of the TFSA questions and answers is reproduced below:

* * *

### 5. Non-qualified investments

#### 5.1 What are the reporting requirements if the TFSA holds a non-qualified investment?

If at any time in a taxation year the TFSA holds non-qualified investments, the TFSA trust will be taxable on any income earned or capital gains realized from the non-qualified investments and the issuer will be required to file a T3 Trust Income Tax and Information Return. In addition, prescribed information will have to be reported on the TFSA annual report. Given that TFSA holders are liable for Part XI.01 tax, TFSA issuers will have

to advise them before March of the following year that the TFSA trust holds non-qualified investments and will also have to provide holders with the necessary information (see note below) to allow them to calculate the tax and/or refund.

**Note:**

The necessary information includes, at the time the non-qualified investment is acquired or it became non-qualified, the description of the investment (name, number of share, etc.), the date and the FMV at that time. At the time the non-qualified investment is disposed of or it became qualified, the same information is also required at that time.

**5.2 Will the 50% tax on non-qualified investments apply to more than one year?**

This is a one time tax that becomes payable by the holder at the time the trust acquires a non-qualified investment or when the property becomes a non-qualified investment.

**5.3 Will the CRA permit a period of time to rectify the holding of non-qualified investments related to the 50% tax?**

No. However, the holder may be entitled to a refund if the non-qualified investment is disposed of before the end of the calendar year following the calendar year in which the tax arose. The holder will not be entitled to a refund if it is reasonable to expect that the holder knew or ought to have known at the time the property was acquired by the TFSA trust that the property was or would become a non-qualified investment.

## 6. Fees

**6.1 How will TFSA fees be treated?**

The payment of management fees by the holder that relate to a TFSA trust will not constitute a contribution to the TFSA and the payment of investment counsel fees by a TFSA trust will not result in a distribution from the TFSA trust. Any fees paid are not deductible for income tax purposes.

**Note:**

The position adopted for TFSAs is based on CRA's current position concerning trusteed RRSP fees. If there are questions on the treatment of other types of fees, please write to the Income Tax Rulings Directorate.

## 7. Transfers on Death

**7.1 Can a TFSA plan holder name his or her spouse or common-law partner as the successor holder on the TFSA plan documents?**

Yes. This means that upon the death of the plan holder, the successor holder will become the new plan holder and the TFSA will maintain its tax exempt status.

**7.2 What happens to a trusteed TFSA that ceases to be a TFSA because of the death of the holder?**

Under proposed legislation, the arrangement is deemed for certain provisions of the Act to continue to be a TFSA until the end of the year following the year in which the holder dies or when the trust ceases to exist, if earlier. The main effect of this deemed rule is that the trust continues to maintain its tax-exempt status during this exempt period.

Any payments made by the trust to the beneficiary during this exempt period are required to be included in the beneficiary's income to the extent that the payment represents the distribution of income earned on, or appreciation in the value of, the trust's property during the exempt period. This payment will have to be reported on a T4A as "other income".

If the TFSA still exists after the exempt period, the trust will be taxable from that point forward and will be treated as having disposed of, and reacquired, its property for its FMV at that time. The issuer will be required to file a T3 Trust Income Tax and Information Return for every year beyond the exempt period that the estate remains unsettled.

**7.3 Where a TFSA ceases to be a TFSA because of the death of the holder, can the survivor (spouse or common-law partner) transfer a payment from the deceased holder's TFSA into their own TFSA without affecting their own TFSA contribution room?**

Under certain conditions and limits, the survivor may contribute an amount into their own TFSA without affecting their own TFSA contribution room. One of the conditions is that the survivor must designate these contributions as exempt contributions by filing with the CRA a prescribed form within 30 days of making the contribution. In addition, the contributions must be made within the end of the year, after the year of death of the deceased spouse. Upon receiving the prescribed form, CRA will disregard these contributions in the calculation of the TFSA room limit. These contributions must be reported by the financial industry as regular contributions.

### 8. Non-residents

**8.1 Can a holder contribute to a TFSA while a non-resident?**

Any contributions made while the individual is a non-resident will be subject to a special tax of one per cent per month of the contribution until the individual withdraws and designates the withdrawal as a withdrawal of the non-resident contribution or, if earlier, the individual becomes resident in Canada. In addition, as no contribution room would accrue for any year throughout which the holder is a non-resident, the individual will be subject to another one per cent tax per month of the contribution on any excess TFSA amount.

**8.2 Can non-residents make withdrawals from their TFSAs?**

Yes. Any withdrawals made during the period that the holder is a non-resident will be added back to the holder's unused TFSA contribution room in the following year but will only be available when the holder subsequently resumes residency status in Canada.

**8.3 Does Part XIII tax apply on any earnings in their accounts or on withdrawals made by a non-resident?**

Non-residents would not be taxed on any earnings in their accounts or on withdrawals. However, any payments made by the trust to a non-resident beneficiary, from a deceased holder's TFSA, during the exempt period is required to be included in the beneficiary's income to the extent that the payment represents the distribution of income earned on, or appreciation in the value of, the trust's property during the exempt period. On such payments Part XIII tax has to be withheld.

### 9. Trade date versus settlement date

**9.1 Which date must the financial institution report to CRA as the transaction date?**

The Income Tax Rulings Directorate is currently determining what reporting date must be used. We will provide this information as soon as it is available.

### 10. Reporting withdrawals (distributions)

**10.1 Must the financial institution report overcontribution withdrawals?**

No. These withdrawals must be reported by the financial industry as regular withdrawals (distributions) as CRA will be calculating the overcontribution based on the information reported on the Annual Information Return.

**10.2 Must the financial institution report transfers under the contribution and withdrawal (distribution) fields?**

No. Transfers must not be reported as contributions or withdrawals. Transfers between TFSA accounts of the same holder are not to be reported. Transfers resulting from a marriage breakdown must be reported in the marriage breakdown field.

**10.3 Does the CRA require TFSA issuers to use a prescribed form for processing TFSA transfers between financial institutions?**

No. CRA will not be prescribing a form for TFSA issuers to report TFSA transfers between financial institutions.

### 11. Contributions in "kind"

**11.1 Can an individual make the eligible contribution in cash only or can the contribution also be made "in kind"?**

Individuals will be allowed to make in kind contributions to their TFSA, provided that the property is a qualified investment. As is the case with RRSPs, the individual will be considered to have disposed of the property for its fair market value at the time of the contribution. If the fair market value exceeds the cost of the property, the individual will have to report the capital gain in their income tax return. However, if the cost exceeds the fair market value, the resulting capital loss cannot be claimed. The amount of the contribution will be equal to the fair market value of the property.

# Recent Technical Interpretations

## Principal Residence – Waterfront Property Used by Houseboat

As noted in Interpretation Bulletin IT-120R6, a houseboat can qualify as a taxpayer's principal residence. A principal residence also includes "the land subjacent to the housing unit" and a portion "of any immediately contiguous land as can reasonably be regarded as contributing to the use and enjoyment of the housing unit as a residence". The issue the CRA was asked to comment on was whether a waterfront property where a houseboat was moored would qualify for the principal residence exemption in paragraph 40(2)(b).

Referring to the decision in *Glen M. Windrim v. The Queen*, 91 DTC 5221 (F.C.T.D.), the CRA noted "we envision difficulties finding that the float home has any contiguous land necessary to its use and enjoyment, as the essence of the float home as a housing unit is mobility". In *Windrim*,

the Court considered whether a 17.6 acre parcel of land on which a 35-foot mobile trailer home was located, formed part of the taxpayer's principal residence. (The CRA had accepted that two hectares of the land were part of the taxpayer's principal residence.)

The Court in *Windrim* noted:

> Here, the plaintiff did not build his home, but rather placed a couple of trailers which, it appears were never affixed to and part of the realty, such that one doubts if they or it (the plaintiff's one housing unit at a time) ever really had any land subjacent to it or any immediately contiguous land. Giving the taxpayer the benefit of any doubt on that score, the Court locates the taxpayer's housing unit as the place upon which the 35-foot mobile home was temporarily resting prior to the purchase, but truly that is an evanescent finding because that mobile would-be housing unit was sold separately from the land. It really does not qualify, in these circumstances, as a housing-unit which can be fixed upon the land claimed as the plaintiff's residence, because there was way so much more land than was needed for the mobile home, which was in no way confined to any one place upon it.

The Court went on to state that "where the taxpayer's/homeowner's housing unit is a mobile home which is capable of going whither he or she goes, how can one readily identify any land subjacent to [that] housing unit and such portion of any immediately contiguous land as may reasonably be regarded as contributing to the taxpayer's use and enjoyment of [that] housing unit?"

Document No. 2008-0271331E5, June 4, 2008

## Bump in ACB of Non-Depreciable Capital Property – Acquisition of Property by Specified Persons

Subparagraph 88(1)(*c*)(iv) denies the bump under paragraph 88(1)(*c*) with respect to property distributed on a winding-up or acquired on an amalgamation that is acquired by a person other than a specified person as defined in 88(1)(*c*.2). The denial of the bump is related to the restriction on the so-called "purchase butterfly" that is intended to prevent an arm's length sale of corporate assets on a tax-deferred basis. A specified person is defined in paragraph 88(1)(*c*.2) as the parent corporation and essentially each person that is related to the parent corporation. In a comfort letter issued on February 23, 2007, the Department of Finance indicated that a recommendation would be made that the definition of specified person would be amended to "include a person that is related to the parent (within the meaning of subparagraph 88(1)(*c*.2)(i)) from the time the parent was incorporated until the beginning of the winding-up of the subsidiary". The suggested amendment is intended to deal with a "concern that a person cannot be a specified person before the incorporation of the parent corporation".

The suggested amendment to paragraph 88(1)(*c*.2) was dealt with by the CRA in a tax ruling where a favourable opinion was given that "the provisions of subsections 87(11) and 88(1) would apply to the vertical amalgamation of Target and Newco 1 to form Amalco I" as described in the ruling. The opinion is subject to a caveat regarding the acquisition of property by a person described in any of subclauses 88(1)(*c*)(vi)(B)(I), (II), or (III). A related GAAR opinion was also given. No rulings were given.

Newco 1 was incorporated by Bidco, an indirect subsidiary of Buyerco. Without the suggested amendment to paragraph 88(1)(*c*.2), the various corporations in the Buyerco group of companies would not have been related to Newco 1 prior to its incorporation. The transactions in the ruling include the acquisition of property that is "substituted property" described in paragraph 88(1)(*c*.3) by companies in the Buyerco group prior to the incorporation of Newco 1.

Document No. 2008-0268041R3, August 13, 2008

## Pension Benefits – Lump-Sum Payments Made to Members of a Registered Pension Plan

The transaction the CRA was asked to rule on involved a municipality exempt from tax under paragraph 149(1)(*c*) of the Act that implemented a defined-benefit registered pension plan, of which it was the sponsor and administrator, for the benefit of its civic employees. The plan provided for no cost-of-living adjustment of the pension benefits, which had severe financial implications for low-income retirees, some whom received the Guaranteed Income Supplement. Following the representations made by the retirees regarding the erosion of their pension income, the municipality and the union agreed to compensate them for the non-indexation of their pensions by paying them lump-sum amounts, even if the plan only allowed for the payment of pension annuities and the municipality was under no obligation to pay those lump-sum amounts. Under the agreement concluded by the municipality and the union, the municipality would make a lump-sum payment to each plan member or survivor spouse of a deceased plan member who was a beneficiary under the plan on a given date. In exchange, the union would agree to renounce and transfer to the municipality a part of the plan's future actuarial gains (up to an amount equal to a percentage of the lump-sum payments), which would bear interest from the date the payments were made until the date the municipality is fully reimbursed. The payments would be made from the municipality's general funds, not in accordance with the plan bylaws. The purpose of the operation was to correct the non-indexing of the pension benefits without

preventing the retirees and their surviving spouses from receiving the Guaranteed Income Supplement. The CRA was asked if the lump-sum payments would be taxable under paragraph 56(1)(a)(i) of the Act.

The CRA ruled that the lump-sum payments that the municipality would make to those retired employees would be made on account of, or in satisfaction of, a superannuation or pension benefit and, as a result, would be taxable under paragraph 56(1)(a)(i) of the Act for the year in which they are received.

Document No. 2007-0262301R3, July 16, 2008

## Private Health Services Plan Managed by a Health and Welfare Trust – Self-Insurance of the Benefits

The issue the CRA was asked to review involved a trust administering an inter-company health services plan. Both the incorporated and non-incorporated members of a provincial professional order were entitled to participate in the plan to provide health benefits to their employees and their dependants. The plan had two components: a basic one for which the employers paid the contributions set by the trustees and an optional one at cost-plus. The contributions were used to pay the premiums required for insurance coverage provided under a group insurance contract signed with an insurance company and to finance the plan's administration costs. The insurer paid all the eligible claims made by the employees and their dependants during the year, up to certain limits set in the group insurance contract. The trustees wanted to self-insure the health and welfare insurance benefits that were currently paid by the insurer in respect of the basic component of the plan. The CRA was asked if a plan considered to be a "private health services plan" ("PHSP") within the meaning of this term in subsection 248(1) of the Act and being managed by a health and welfare trust would continue to be viewed as a PHSP if certain benefits paid under the plan were to become self-insured.

Relying on paragraph 7 of IT-339R2, the CRA confirmed that an arrangement under which an employer reimbursed its employees for the cost of medical or hospital care could be considered to be a PHSP. This would be the case if the employer was required by its employment contract to reimburse these types of expenses incurred and claimed by the employees or their dependants. The consideration given by the employees would be considered to be the covenants found in the collective agreement or contract of service.

The simple fact that the health benefits paid under a plan may become self-insured would not prevent the plan from being considered a PHSP if the other conditions to qualify as a PHSP were met. To qualify as a PHSP, the plan had to be an insurance plan that included the following element: hiring a person who would indemnify another person, in exchange for an agreed consideration, after a loss was incurred or an obligation was contracted in respect of an event, the outcome of which was uncertain. Since the CRA could not review the trust agreement and insurance contracts, it could not confirm with certainty if the plan was a PHSP for the purpose of the Act. As noted in *Income Tax Technical News* No. 25 and IT-85R2, the employers could operate their own health and welfare plans in accordance with a trust agreement, but their contributions to the fund managed by the trust could not exceed the amounts required to provide the health and welfare benefits.

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