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Tax Notes

June 2009
Number 557

Tax and Family Business Succession Planning – What's New

We are currently working on the third edition of *Tax and Family Business Succession Planning*, for fall publication by CCH Canadian Limited. This publication seems to have caught a wave of popularity: family business succession planning and tax planning for wealthy families continue to be hot topics.[1]

Given that the new edition follows the second edition fairly closely, one might ask what has happened in the last couple of years to merit another edition. Actually, a lot.

In general, recent reductions in corporate tax rates, along with the eligible dividend rules, have resulted in a greater bias to retain profits at the corporate level rather than distributing them as salaries/bonuses, thus militating in favour of freezes.[2] In the last few years, this trend has continued. Changes stemming from the November 2007 federal announcements will result in decreasing corporate tax rates, until federal rates reach a mere 15% in 2012.[3] This year's Ontario Budget also removed barriers to retaining income at the corporate level.[4] In that province, the general corporate business rate in 2014 will be less than 53% of the applicable rate where income is bonused out.

Hardly a Week Goes By . . .

It is hard to remember a week that has gone by without a new development pertaining to the book. In the week before publication of this article, there were at least four relevant developments that I have come across (so far!). The Federal Court of Appeal released its decision on *Copthorne*;[5] to no one's surprise, the Court (which usually sides in favour of the CRA) upheld the lower Court's verdict that the paid-up capital inflation plan in question contravened GAAR. But the Court also strengthened the series of transactions anti-avoidance concept which is key to many planning manoeuvres, by pouring cold water on the notion that there must be a "strong nexus" between the series of transactions itself and transactions in contemplation of the series, instead looking to a "motivating factor" test.

Inside

An article by Richard Wise in the latest issue of *Canadian Tax Highlights* speaks to the value of an interest in a discretionary trust.[6] Another article in the same issue[7] indicates that the 2009 federal Budget provisions to remedy the result in *La Survivance*[8] (which, for example, could play havoc with the capital gains exemption on a share sale to a public company or non-resident) has deficiencies when CCPC status of a target corporation is to be claimed on a "sign-and-close" transaction.[9] *Propep Inc. v. The Queen*,[10] a civil law case, seems to support a narrow interpretation of "beneficiary" e.g., for the purposes of the look through association rules in subsection 256(1.2).[11]

Going further back in time, in the *Frye* case,[12] the Ontario Court of Appeal held that a specific bequest of shares "trumped" restrictions on ownership in a shareholders' agreement. Some other recent developments we will mention include CRA restrictions pertaining to stock dividend freezes,[13] technical interpretations pertaining to assets used in an active business for the purposes of the capital gains exemption, and developments in respect of distributions from trusts to non-resident beneficiaries.

APFF Stuff

Some of the most interesting new developments come from the Association de Planification Fiscal et Financière (APFF) Round Tables. In the APFF 2007 Round Table, there were a series of questions on the effect of freeze structures involving family trusts on the tax consequences of various situations pertaining to an operating business. The questions focused on the deductibility of bonuses, the tax treatment of a bad loan from a freezor to a frozen corporation, the deductibility of interest on a freezor's borrowings to make an interest-free loan to a frozen corporation, etc.[14] Another question, from the 2008 APFF Round Table, elaborates on an earlier technical interpretation[15] specifying that, for the purposes of the association rules, trustees are considered to own shares held by a trust.[16] Other recent APFF questions give an update on the CRA's views in respect of the attributes of estate freeze preferred shares,[17] and canvass the advisability of adding restrictions on the assignability of interests in certain trusts.[18]

If you read this newsletter regularly, you will know that, in recent months, the "control premium" issue has surfaced – that is, whether there is a premium attributable to voting control in isolation (e.g., as would be the case for so-called "thin-voting" shares).[19] Originally, this seemed to be a local (west coast) issue; but more recent CRA statements – that a willing buyer will pay "some amount" for a control premium position[20] – has put practitioners on notice that, in theory at least, this is a Canada-wide issue. At time of writing, the reaction of practitioners in dealing with this issue is still unfolding; and based on discussions with leading valuators, we think that the premium in a freeze structure – that is, where a freezor has access to only limited dividends – is modest, notwithstanding the CRA's apparent position.[21]

While this issue is now well known, what might not be is that some of the methodology that might be used to counter a control premium gives rise to other technical issues. In particular, when shares pass in and out of an estate, there is presumably an acquisition of control, with the loss-streaming rules, etc., being potentially applicable. Happily, though, there are certain "saving rules" in subsection 256(7) that usually alleviate the acquisition of control issues in these situations. However, particularly where voting rights are designed to drop off on death, we think that there are some imperfections in these "saving rules".

Other Stuff

Another area that we intend to discuss in more detail is trusts and the association rules. For example, one specific rule deems shares held in a discretionary trust to be owned by each discretionary beneficiary;[22] another rule – also typically applicable to freezes using a family trust – deems common shares having more than 50% of the fair market value of all of the issued common shares to be a control block.[23] While these rules have been around for quite a while, there is a growing realization that, as the freeze "matures", association issues can sometimes become acute. Consider, for example, a situation where a freeze is done in favour of a discretionary trust with teenagers as beneficiaries. The prospect of their kids becoming suc-

TAX NOTES

Published monthly by CCH Canadian Limited. For subscription information, see your CCH Account Manager or call 1-800-268-4522 or (416) 224-2248 (Toronto).

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CIRCULATION DEPT.
330–123 MAIN ST
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cessful business owners is probably the last thing that most freezors have on their minds. However, what with high-tech opportunities and the like, it is often not too long before the kids become successful in their own right. Of course, this may give rise to association issues if one or more of them controls his or her own company, including having to share the small business deduction and the potential loss of SR&ED credits. In the third edition, we will expand the discussion of strategies that can be used to deal with this issue.

In addition to a discussion of the capital gains exemption, including crystallization methodology, we intend to add a discussion of purification strategies that can result in the multiplication of the capital gains exemption, by being able to maintain the corporation as a qualifying small business corporation. Also added will be new materials pertaining to testamentary trust status, expanded discussion of family business shareholders' agreements, and many other features.

As discussed above, recent developments are putting more and more emphasis on a detailed knowledge of tax issues – especially pertaining to the taxation of private corporations. My personal belief is that the area of family business succession planning is steadily moving further into this realm.

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Tax and Family Business Succession Planning was recently honoured by being selected by the *Financial Post Magazine* as a recommended resource for the "Entrepreneur's Toolkit" as part of their feature on succession planning (*Financial Post Magazine*, May 2009).

Notes:

[1] For example, since the second edition was published, the Ontario Bar Association has presented two all-day sessions on the subject: "Taxation of Trusts and Estates: A Practical Approach", March 3, 2008 and "Tax For Succession Planning, Trusts and Estates Practitioners", March 3, 2009.

[2] I.e., because of the increased death tax exposure attributable to retained earnings buildups.

[3] As I have pointed out previously, dropping corporate tax rates have resulted in higher tax on eligible dividends, such that there will be very little difference between the federal taxation of eligible and ineligible dividends when the changes to corporate federal rates are fully phased-in by 2012.

[4] Notably, the elimination of the "clawback" – a corporate tax in excess of 4%, applicable to corporate income between $500,000 and $1.5 million. The tax is sufficiently high to call into question the advisability of retaining profits at the corporate level, at least within this income range – obviously relevant to a great many Ontario businesses. Once the clawback is eliminated in July 2010, Ontario corporations will have a greater incentive to retain profits at the corporate level, especially since the general provincial corporate rate will be reduced from the current 14% rate to 10% by 2014, bringing the combined federal–provincial rate in Ontario to 25%. For further discussion, reference should be made to "Corporate Deferral Strategies, Dalton McGuinty and Joe the Plumber", by the author and Michael Goldberg, TAX NOTES No. 556, May 2009.

[5] *Copthorne Holdings Limited v. The Queen*, 2009 FCA 163.

[6] "Trust Interest Valuation", page 9. The author concludes: "In a discretionary trust, there is no definite economic interest in either an income or a capital interest unless the vendor happens to be the sole beneficiary in the trust income or capital; in any event, FMV is speculative at best."

[7] "Part-Time CCPCs Again", Joel Nitikman and Michelle Moriartey, page 6.

[8] *La Survivance v. The Queen*, 2007 DTC 5096, (FCA).

[9] Because the deemed year-end at the commencement of the day of control change does not affect CCPC (and SBC) status, the target would not be a CCPC throughout the year in which control is acquired – i.e., because for these purposes, the change of status (if applicable) would occur later in the day.

[10] 2007-1882(IT)G.

[11] Essentially the case held that a "second ranking" beneficiary under the *Civil Code of Quebec* whose interest was conditional on the winding up of a corporation which was a "first ranking" beneficiary was not a beneficiary for the purpose of subparagraph 256(1.2)(*f*)(ii), indicating that "if a beneficiary's right is subject to a condition, the condition must be realized in order for the beneficiary to be able to exercise the right" (paragraph 41).

[12] *Frye v. Frye Estate*, 2008 ONCA 606.

[13] Doc. No. 2003-0004125, April 1, 2003 – French only.

[14] 2007 APFF Round Table, Question 14.

[15] Doc. No. 2005-0111731E5, July 4, 2006.

[16] Doc. No. 2008-0285021C6; 2008 APFF Round Table, Question 10.

[17] Doc. No. 2008-0285241C6, 2008 APFF Round Table, Question 23.

[18] Doc. No. 2008-0285071C6, 2008 APFF Round Table, Question 14.

[19] See "Valuation and Family-Business Share Structures – Some Musings", by the author (TAX NOTES No. 549, October 2008).

[20] See Income Tax Technical News No. 38, September 22, 2008.

[21] However, exclusionary dividend structures may be another story – e.g., common-type shares on which open-ended dividends can be paid on one class to the exclusion of other classes – I believe that this feature, coupled with voting control, could potentially result in a considerably more significant premium. This may be problematic, for example, where non-voting exclusionary dividend shares are used in an attempt to multiply the capital gains exemption.

[22] Subparagraph 256(1.2)(*f*)(ii).

[23] Subparagraph 256(1.2)(*c*)(ii). Similarly, by virtue of subparagraph 256(1.2)(*c*)(i), there will be deemed control in respect of shares of any class having more than 50% of the fair market value of all of the issued shares.

Amended Regulations Re Capital Cost Allowance

The Income Tax Regulations in Part XI and Schedule II have been amended pursuant to P.C. 2009-660, SOR/2009-126, dated April 30, 2009. These regulations, relating to capital cost allowance proposals announced in the 2008 and 2009 federal Budgets, have been posted on CCH Tax PROTOS® and CCH's News Tracker and will be

added to the Income Tax Regulations in Volume 4 for print, and on DVD and online as soon as possible. The description of these amendments from the Regulatory Impact Analysis Statement relating to these regulations is reproduced below. The Department of Finance has confirmed that Class 52, concerning the 100% write-off of general-purpose electronic data processing equipment and systems software for that equipment, applies for property acquired by the taxpayer after January 27, 2009 and before February 2011, as was stated in the 2009 federal Budget, rather than to property acquired after January 27, 2009 and before February 2010, as described in the regulations. Revised regulations will have to be introduced to correct this error.

Description

These amendments implement the following measures proposed in the February 26, 2008 Budget. Unless indicated otherwise, they apply to eligible assets acquired after February 25, 2008.

- The temporary accelerated 50% straight-line CCA rate (Class 29) for machinery and equipment used primarily in Canadian manufacturing and processing (M&P) activity (applicable to assets acquired after 2008 and before 2010) is extended for an additional year. (See below for a further extension to 2012.)
- The CCA rate is increased for carbon dioxide pipelines to 8% (Class 49) from 4% (Class 1).
- The CCA rate is increased for new railway locomotives to 30% (Class 10) from 15% (Class 7).

The 2008 Budget Plan also included certain proposals that concern clean energy assets included in Class 43.1 (30% CCA rate) and Class 43.2 (50% CCA rate). A draft of those proposals was included in the 2008 Budget Plan documents at pages 391 to 402 [CCH Special Report 033H, dated February 26, 2008]. The draft of those proposals was not ready for inclusion in the present package of regulatory changes. The intent is to include those proposals in a subsequent package in order not to delay the publication of the present package.

The amendments also implement the following measures proposed in the January 27, 2009 Budget.

- The temporary accelerated 50-per-cent straight-line CCA rate (Class 29) for machinery and equipment used primarily in Canadian manufacturing and processing (M&P) activity (applicable to assets acquired after 2008 and before 2012) is extended for an additional two years, 2010 and 2011.
- The CCA rate is increased for certain computers and systems software to 100% (new Class 52) from 55% (Class 50). This measure is temporary in nature and applies to eligible assets acquired on or after January 28, 2009 and before February 2010 [*sic* 2011].

Recent Technical Interpretations

Qualification as Farm Property Following the Death of the Spouse

This question involved a situation where a husband inherited a farming property from his father, who had carried on a farming business until his death. The husband maintained a separate employment but always regarded the land as "qualified farm property" pursuant to s. 110.6(1), since the land was acquired from his father for whom farming represented the principal source of income. The husband bequeathed the farming property to his wife on his death and she utilized the land for two years before selling it.

"Qualified farm property" is property used principally in the course of carrying on the business of farming by the individual, his or her spouse, child, or parent. Reference to father or mother includes the father or mother of the taxpayer's spouse pursuant to s. 252(2). Following the death of a spouse, however, a taxpayer will cease to be connected by marriage to the parents of the former spouse. The taxpayer concluded that this would mean that the father of the husband would no longer be considered the father of the wife, following the husband's death. As such, the property transferred by the wife would not have been "qualified farm property" to the wife.

The CRA was asked whether Appendix A of Interpretation Bulletin IT-513R, *Personal Tax Credits* could apply. It provides ". . . for the purposes of the equivalent-to-spouse tax credit and the dependent tax credit, when a marriage has been dissolved by death, the family relationships created by the marriage continue to exist. For example, a man or woman is considered to remain a child of his or her deceased spouse's mother or father".

The CRA stated that this would only apply for those particular tax credits mentioned therein. However, the CRA nevertheless concluded that the property would be considered "qualified farm property". For the purposes of the definition of "qualified farm property", the property must meet an ownership test and a gross revenue test, as indicated in s. 110.6(1.3). The ownership test was met since it requires that the property be owned by the individual, her spouse, child, parent, or a family farm corporation of the individual for a period of two years preceding its disposition. The gross revenue test in s. 110.6(1.3)(b) could only be met by the father of the late husband, since he carried on the farming business as his principal source of income for at least two years. The CRA was of the view that this test could be conducted for the period when the family relationship existed between the wife and her husband's father in order to determine if the father met the requirements. In this case, the CRA stated that the test would be met for purposes of the definition of qualified farm property.

Document No. 2008-0285271C6, October 10, 2008

Capital Dividend Account and Life Insurance as Security for Indebtedness

The CRA was asked whether it intended to change its position in paragraph 6 of Interpretation Bulletin IT-430R3 in light of the taxpayer's successful settlement in *Canadian Motivel Inc. v. The Queen* (2006-3071(IT)G).

Paragraph 6 of IT-430R3 states the CRA's position that where a life insurance policy has been assigned as collateral for securing indebtedness and the debtor remains the beneficiary or policyholder, the proceeds in excess of the adjusted cost basis of the policy would be included in the corporate debtor's capital dividend account. This is because the CRA considers that the debtor constructively received the proceeds of the insurance policy even though such amount was paid directly to the creditor.

In *Canadian Motivel*, ACo's loans were insured by Sun Life. Royal Bank was the creditor and beneficiary. Upon the death of one of ACo's shareholders, the insurance was used to repay the existing loans and Sun Life paid the insurance proceeds directly to Royal Bank as beneficiary. ACo added an amount to its capital dividend account and paid the surviving shareholder a capital dividend. The CRA reassessed for excess payment of a capital dividend. ACo argued that paragraph (d) in the definition of "capital dividend account" in s. 89 requires only that the corporation receive insurance proceeds – there is no requirement that the corporation remain a beneficiary or policyholder.

Canadian Motivel was settled before the Tax Court rendered a decision, and the CRA appears to be unmoved in its interpretation of paragraph (d) of the definition of "capital dividend account". The CRA's view is that there is no constructive receipt by the debtor where it has made an absolute assignment of the life insurance policy, where the creditor subscribed to the life insurance policy, or where the debtor is neither the policyholder nor the beneficiary.

Document No. 2008-0289441C6, October 10, 2008

Self-Benefit Trust Pursuant to Section 73 of the ITA

The CRA was asked to explain the tax consequences in a hypothetical situation where an individual residing in Quebec established a self-benefit trust and thereafter decided to sell his interest in the trust.

The individual would transfer an income-producing building to a self-benefit trust (within the meaning of s. 73(1)). The building has a fair market value of $1 million, an adjusted cost base of $600,000 and an undepreciated capital cost of $400,000. The individual would be the sole beneficiary of the trust, he would be entitled to receive the income of the trust, and no other person would be entitled to receive or obtain the capital of the trust. Thereafter, the individual decides to sell his interest in the trust to a third party for $1 million.

The CRA stated that in determining whether or not the building was rolled over to the trust under s. 73(1), the usual rules would apply in respect of the transfer of an interest in a trust. The disposition of the income interest and capital interest would result in different tax consequences. The selling price would have to be allocated between these two interests. If the two parties are not dealing at arm's-length and the proceeds of disposition are less than fair market value, s. 69(1)(b)(i) would deem the transferor to have received proceeds of disposition equal to the fair market value of each type of interest disposed of. The disposition of the income interest would be addressed under s. 106(2) and the disposition of the capital interest would be addressed under s. 107(1).

However, the CRA noted that, in this case, the transfer would not be eligible for rollover treatment under s. 73(1) because the requirements of s. 73(1.01)(c)(ii) would not be met (i.e., the potential third party transferee would be entitled to receive the income or capital of the trust before the individual's death).

Document No. 2008-0285071C6, October 10, 2008

Specified Beneficiary in a Personal Trust

The situation the CRA was asked to consider involved the parents of children who were beneficiaries under a personal trust that held the deed to the house in which they were living. Under the trust agreement, the parents had a right in the distribution of the capital in the trust up to an amount that would have been paid to one of the children should that child have died before receiving all or a portion of his/her interest in the trust capital. The CRA was asked if a parent could be viewed as a "specified beneficiary" within the meaning of this expression in subparagraph (c.1)(ii) of the definition of "principal residence" in s. 54 of the Act.

The CRA confirmed that the parents would probably be considered specified beneficiaries under the above provision because they were ordinarily inhabiting the house during the years in question and were "beneficially interested" in the trust within the meaning of the expression in s. 248(25) of the Act. Under that provision, a person who is beneficially interested would include one having a right as a beneficiary under a trust to receive any income or capital of the trust regardless of whether the right was exercised immediately or in the future, was absolute or contingent, or was conditional on or subject to the exercise of any discretion by any person or partnership. The CRA considered that since the trust agreement provided that the parents would be entitled to the capital of the trust in accordance with the law governing the death *ab intestat* of the beneficiary children, the parents could be considered as beneficially interested in the trust. They could thus be considered specified beneficiaries for the purpose of the designation by the personal trust of the house as principal residence for a particular taxation year within the meaning of this term in subparagraph (c.1)(ii) of the definition of "principal residence" in s. 54 of the Act. The CRA noted that the designation of the house as a principal residence would only be valid if the designation was done by the

trust in prescribed form and included the name of each specified beneficiary of the trust.

Document No. 2008-0289721E5, March 3, 2009

Long-Term Disability and Survivor Benefits Received by an Estate

The situation the CRA was asked to comment on involved an individual suffering from a disease that prevented him from exercising his employment duties and in respect of which he received long-term disability benefits for a certain period of time. The benefits were paid under a collective agreement with an insurance company. At some point, the insurer stopped paying the benefits, considering that the individual was well enough to return to work. Before his death in 2007, the individual instituted legal proceedings to recover those unpaid benefits. In 2008, the estate and the insurer reached an out-of-court settlement under which the estate received not only the long-term disability benefits payable to the individual while he was alive but also survivor benefits payable to his spouse. The CRA was asked if the long-term disability benefits received by the estate would have been considered as an income from an office or employment if they had instead been received by the individual when he was still alive. The CRA was also asked if the long-term disability benefits and survivor benefits received by the estate following the settlement would be taxable and, if so, how they would be taxed. More specifically, the CRA was asked if the amount received by the estate in respect of the long-term disability benefits could be characterized as a "right or thing" that was taxable to the deceased under a separate tax return to the extent the benefit was provided under a collective agreement with the insurer that was in force before the individual's death.

Regarding the first question, the CRA relied on paragraph 1 of IT-428 and the decision of the Supreme Court of Canada in *Vasiliki Tsiaprailis v. The Queen* (2005 DTC 5119) to conclude that the long-term disability benefits received by the individual while he was alive would be included in his income under s. 6(1)(f) of the Act. To reach its conclusion, the CRA assumed that the benefits were paid to the individual on a periodic basis by the insurer in accordance with a wage loss replacement plan similar to the one described in paragraph 1 of IT-428 and to which his employer had made contributions. The CRA noted that the income inclusion could be reduced by any contributions made by the employee to the plan if those contributions were made after 1967. Regarding the second question, the CRA considered that the portion of the settlement that was received by the estate in 2008 and that was related to the overdue long-term disability benefits could be treated as a "right or thing" since, at the time of his death, the individual had a legal right to receive those benefits and that the amount could be determined by the parties. Regarding the survivor benefit, the CRA assumed that this benefit was an integral component of the long-term disability insurance plan and that it would therefore qualify as a "death benefit" within the meaning of this term in s. 248(1) of the Act. If this was the case, the beneficiary of the survivor benefit would have to include the death benefit in his/her income in accordance with s. 56(1)(a)(iii) of the Act. The CRA noted that the amount received by the estate in respect of the survivor benefit would have to be in recognition of the individual's services rendered in the course of his employment to qualify as a death benefit, which would of course be a question of fact.

Document No. 2008-0293131E5, March 23, 2009

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