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Some Thoughts on Estate Plans

In this article, I would like to impart some personal perspectives on the estate and succession planning process for owner-managers and their families. In most instances, the centrepiece of an estate plan is the estate freeze, so I will refer to this particular structure throughout this article.

How should a professional advisor approach an estate planning structure for a client and his or her family?

First, my personal preference is to keep it on the simple side. We should not lose sight of the fact that an estate freeze is a long-term structure, which should be able to stand the test of time. For example, over the years, the CRA has provided some comfort on various technical points, often forming the basis of a sophisticated estate freeze structure. But one should look closely at the parameters of such administrative largesse and perhaps even query whether it will continue to exist a couple of decades from now.[1]

Sometimes defects can surface or new issues emerge. To give just one example, in the course of updating *Tax and Family Business Succession Planning* (the 3rd edition will be coming out soon), we came across a fairly recent French-language technical interpretation indicating that the CRA apparently has an issue with price adjustment clauses in a stock dividend freeze.[2] Since this form of freeze is something of a rarity, this will be of little interest to most advisors – except of course those who have been using this structure.

Going with conventional structures may be another good move. If you get into esoterica, you may be find yourself swimming upstream one day. For example, it is possible that there could be new legislation which may have an unintended result that could adversely affect the particular structure. If you go with the crowd and it turns out there is a problem with new legislation, there will be lots of others in the same boat; more often than not, the problem will be fixed. If you are off on a tangent, chances are you may not get the ear of the Department of Finance, much less sympathy.[3]

Inside

Changes in the Family

Think about changes to family circumstances. For example, practitioners are often asked to implement freezes for younger entrepreneurs – often with children in their teens or younger. One day the kids may get married – and then divorced. A marriage contract may not always be possible, and recent Ontario case law indicates that proper disclosure may be a more arduous process than we assumed even a few years ago. So the client should be made aware that family law issues could arise. Consideration might even be given to delaying the freeze until the kids get married, at which time better protective strategies may be available.[4] Apart from this, the kids could become successful and establish their own businesses. Consideration should be given to the potential impact and antidotes to the association rules.

Of course, another possibility could be that the kids move to the United States or abroad. Until the mid-90s, it was possible to distribute the growth shares of a taxable Canadian corporation to a U.S. or other foreign beneficiary without tax. However, subsection 107(5) now prevents this. For beneficiaries resident in the United States, it was frequently possible to deal with this issue by interposing an unlimited liability corporation ("ULC") prior to distribution of the growth shares. But remember that unforeseen legislation I mentioned awhile ago? The Protocol to the Canada–U.S. Treaty has knocked a big hole in this manoeuvre by imposing a 25% rate of withholding on dividends paid by the ULC to the U.S. resident, starting next year. When implementing a family trust, one solution to this is to provide for corporate beneficiaries so as to enable a tax-deferred distribution to a Canadian-resident corporation.[5]

TAX NOTES

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Giving Freezor "All the Strings"

> We are all men who have refused to be fools, who have refused to be puppets dancing on a string pulled by the men on high.
>
> – Vito Corleone

I think most successful businesspeople would have similar sentiments; the desire for control is one of the common traits of successful businesspeople. How do I know this? When a freeze structure is put forward, concerns about loss of control are usually among the first reactions of the client. How many times have we gone out of our way to assure a client that when he or she comes to work the day after the freeze, the sun will still be shining – and more importantly, there won't be someone looking over his or her shoulder?

However, a freeze structure introduces other shareholders. And with other shareholders come duties to them on the part of Freezor, often of the highest order – especially since Freezor will often insist on being the director of Freezeco as well as a trustee of his or her family trust. Notwithstanding the fact that there are other shareholders, the owner-manager is often insistent that he or she be able operate and make decisions unilaterally and without question. Naturally, we advisors want to please the client, and we may do everything possible to make sure that this wish is fulfilled. We may give our clients extraordinary voting rights and design clever ways to undo the freeze. We often implement strategies that our client doesn't fully understand – or sometimes doesn't even know about. The control mechanisms we so enthusiastically implement are inherently designed to put Freezor in a position to disregard the interests of other family members. And by giving Freezor all of the strings, he or she will often be inclined to do just that.

As long as there is family harmony, things will be OK. But kids grow up; the family trust arrangement has to be terminated. Maybe the kids have problems. Maybe they are not getting along with their parents. Maybe there are differing views as to whether kids who aren't in the business or whose marriages could be unstable should still get their share of the growth shares.

If things don't go well within the family, minority shareholder rights and remedies may be asserted. Indeed, if Freezor wants to make an "asymmetrical" distribution from the family trust, the prospect of proceedings against Freezor and fellow trustees for breach of fiduciary duty may be very real – a very wise lawyer once told me that discretionary trusts are not as discretionary we may think.

Besides actions by children, giving Freezor all the strings could be problematic in the family law context. In

Ontario at least, an estranged spouse might argue that the "bells and whistles" Freezor retains in respect of a frozen corporation may militate in favour of a premium over the freeze value.

If a client is insistent on having all the strings, we typically ask how far are we able to go to please the client and achieve this objective. Maybe another question we should be asking is how far *should* we go.

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Notes:

[1] One of the most venerable examples is Question 22 of the 1990 Revenue Canada Round Table, relating to "gels", i.e., where Freezor is a beneficiary of a discretionary family trust. This question may have morphed into a sense on the part of some practitioners that gels have the blessing of the CRA. However, the question and answer pertained to GAAR. The CRA indicated that, depending on the facts, "other provisions of the Act, such as subsections 56(2), 74.1(2), 74.3(1), 74.4(2), 75(2) and 86(2), may have application". The possible application of subsection 75(2) as well as valuation issues in respect to Freezor's interest in a family trust are discussed in *Tax and Family Business Succession Planning*, the 3rd edition of which is to be published by CCH Canadian Limited later this year.

[2] See Document No. 2003-0004125, April 1, 2003.

[3] One problem that never got fixed was the lack of grandfathering rules for subsection 107(4.1), which normally prevents a rollout from a family trust where subsection 75(2) has ever applied to the trust. But even in this case, prior to this provision, it was probably conventional wisdom to ensure that subsection 75(2) did not apply, even though its effect might not have been very problematic.

[4] But what if the kids get divorced and remarry?

[5] For some other suggestions in this regard, see *Tax and Family Business Succession Planning*, 3rd edition.

Prescribed Interest Rates – Third Quarter of 2009

The prescribed interest rates for the third quarter of 2009 are noted below:

- 1% to calculate a deemed interest taxable benefit on subsidized employee and shareholder loans;
- 3% on refunds of income tax overpayments; and
- 5% on payments of overdue income taxes, insufficient income tax instalments, unremitted employee source deductions, CPP contributions or EI premiums, and unpaid penalties.

These rates will be in effect from July 1, 2009 to September 30, 2009.

Home Renovation Tax Credit

On July 13, 2009, the CRA issued a Fact Sheet regarding the home renovation tax credit. To date, this credit, which was proposed in the 2009 federal Budget, has not been passed into law, nor been included in draft legislation. It appears that taxpayers have been writing to their members of Parliament and the CRA asking about the details of this credit. Twelve responses from the CRA on this issue have been released to date and are published in CCH's TAX WINDOW FILE collection. The queries range from general questions concerning what is eligible, to more specific questions, such as whether renovation expenses incurred in November 2008 would be eligible (the answer is "no"; Document No. 2009-0311781M4); whether the installation of a hot tub would qualify (the answer is "it depends on the type of hot tub"; Document Nos. 2009-013571E5 and 2009-0313841E5); whether replacing ceiling fans and light fixtures would qualify (the answer is "if they are of an enduring nature and integral to the dwelling"; Document No. 2009-0309491M4); and whether an eligible dwelling must be a principal residence, as defined in the *Income Tax Act* (the answer is that an eligible dwelling is "a dwelling that is eligible at any time after January 27, 2009 and before February 1, 2010, to be an individual's principal residence or that of one or more of his or her family members"; Document No. 2009-0310361M4). An excerpt from the CRA Fact Sheet is reproduced below.

> The Home Renovation Tax Credit (HRTC) is a temporary non-refundable tax credit that applies to eligible home renovation expenditures for work performed or goods acquired, between January 28, 2009 and January 31, 2010, in respect of an eligible dwelling.
>
> It will provide Canadian families up to $1,350 in tax relief. The credit is calculated as 15% of eligible home renovation expenditures with a total of more than $1,000, and up to $10,000. An estimated 4.6 million Canadian families will benefit from the HRTC.
>
> A new line and schedule will be incorporated in the 2009 personal income tax return to allow Canadians to calculate and claim the credit. The HRTC will not be reduced by any other tax credits or grants to which a taxpayer is entitled for the same expenditures under other government programs. For example, if an eligible expenditure also qualifies for the medical expense tax credit (METC), both the METC and the HRTC can be claimed.
>
> **Eligibility**
>
> The HRTC can be claimed for most renovations or alterations to homes or properties that are enduring in nature. If the item purchased will not become an integral part of your home or property, it is not eligible.

Generally, any dwelling owned by Canadians and used personally by them can qualify, including their homes, condominiums or cottages.

Eligibility for the HRTC will be family based. A family will generally be considered to consist of an individual or an individual and his or her spouse or common-law partner, including children who will be under 18 years of age at the end of 2009. A family will be allowed a single credit that may be shared within the family.

Supporting documentation

Canadians should keep all their receipts and relevant supporting documentation. Appropriate documentation can include agreements, invoices and receipts, and must clearly identify the type and quantity of goods purchased or services provided.

* * *

CRA Extends Administrative Position on Withholding of Refunds for Tax-Exempt Corporations

Reproduced below is a Fact Sheet released by the CRA on July 16, 2009, regarding an extension of its administrative position for tax-exempt corporations with respect to the rules in subsection 164(2.01) of the *Income Tax Act* and subsection 229(2) of the *Excise Tax Act*.

The compliance refund hold legislation became effective on April 1, 2007. In accordance with the provisions contained in subsections 164(2.01) of the *Income Tax Act* and 229(2) of the *Excise Tax Act*, the Canada Revenue Agency (CRA) is required to withhold the payment of rebates and refunds until all required returns under the *Income Tax Act*, the *Excise Tax Act*, the *Excise Act, 2001*, and the *Air Travellers Security Charge Act* have been filed. These legislative provisions may have an administrative impact on corporate entities that are exempted from paying federal income tax under subsection 149(1) of the *Income Tax Act*, in that those entities are, nevertheless, required to file income tax returns pursuant to subparagraph 150(1)(*a*)(i) of the Act.

The CRA implemented an administrative position in 2008 to ease this burden. Pursuant to this position, tax-exempt incorporated municipalities, universities, schools, hospitals, non-profit organizations, federal crown corporations, and Indian band councils did not have their refunds or rebates withheld because of outstanding T2 corporation income tax returns.

This administrative position is being extended to include all tax years up to and including 2010 to allow a CRA internal review to be completed.

For more information about filing a T2 corporation income tax return, go to www.cra.gc.ca/t2return.

Recent Technical Interpretations

Stock Option Benefits

The CRA was asked whether a stock option benefit of a non-resident individual employed in Canada is subject to Canadian tax, and whether employer withholding was required.

The taxpayer was a U.S. resident who was employed in Canada as a director of a Canadian public corporation. The taxpayer received compensation in the form of retainer fees and stock options. The taxpayer provided his employment services to the corporation and not to any other other person and none of his services were performed outside Canada. The fees paid to the taxpayer exceeded $10,000 annually.

The CRA stated that, where the taxpayer exercised an option to acquire shares of the company, the taxpayer would be required to include in his income, by virtue of s. 7 and s. 115(1)(*a*)(i) of the Act, an amount equal to the difference between the fair market value of the shares at the time acquired less the total amount paid by the taxpayer to acquire the option and the amount paid to acquire the share. Where the taxpayer's services are performed in Canada, the entire benefit will be sourced to Canada based on the allocation method set out in Annex B to the 5th Protocol to the *Canada–U.S. Income Tax Convention*.

Further, the taxpayer may be entitled to a 50 per cent deduction of the amount of the benefit under s. 110(1)(*d*) provided that,

(1) the taxpayer was dealing at arm's length with the corporation,

(2) the amount paid by the taxpayer upon exercise of the stock options was not less than the amount by which the FMV of the shares at the time of the option agreement was made exceeds the amount paid by the taxpayer to acquire the options, and

(3) the shares are "prescribed shares" pursuant to s. 6204 of the Income Tax Regulations.

Remuneration paid to a non-resident employee would be subject to the same withholding, remitting and reporting obligations as for Canadian resident employees pursuant to s. 153(1)(*a*) of the Act and s. 102 of the Income Tax Regulations.

The CRA's response raises the issue of the occasionally-overlooked issue of whether a corporate director is an employee under the Act. Under s. 248(1), "employee" includes an "officer", and an "officer" means a person holding an "office", and an "office" includes the position of a corporation director. Accordingly, since directors are employees, the remuneration paid to such persons is taxable as income from an office or employment under, *inter alia*, ss. 5, 6 and 7 of the Act.

– Document No. 2008-0276181E5, May 7, 2009

Back to Back Loans Provisions

The CRA was asked about the operation of s. 118.1(16) and (17) with respect to back to back loans.

Section 118.1 allows individual taxpayers to claim a credit against taxes otherwise payable for an eligible amount of a gift to a qualified donee, if supported by official receipts.

Subsection 118.1(16) provides that for the purpose of s. 118.1, where a person makes a gift to a qualified donee and within 60 months of the date on which the gift was made, the donor or a person with whom the donor does not deal at arm's length uses property of the donee under an agreement that was made or modified after the time that is 60 months before the date of the gift, the fair market value of the gift is the value otherwise determined minus the value of the property so used. Subsection 118.1(17) is an ordering rule that, in effect, reduces the value of the donor's gift and any previous gifts where s. 118.1(16) applies. Additionally, s. 118.1(17) applies on a taxpayer-by-taxpayer basis, such that where s. 118.1(17) operates to reduce the value of the gift of one taxpayer, it may also apply in respect of another taxpayer.

Accordingly, where multiple individuals make donations to a qualified donee and a person not dealing at arm's length with such individuals uses property of the donee, the provision will be applied to each donor separately. For example, where two donor's who do not deal at arm's length make a gift of cash and an amount is loaned back to one of the individuals, the amount of the loan will reduce the fair market value of each of the gifts of the two donors.

Further, there is no provision of the Act that provides for the reinstatement of a gift in the event the property is returned to the charity. The CRA stated that it had brought this result to the attention of the Department of Finance.

– Document No. 2008-0307941E5, May 11, 2009

Professional Corporation's Entitlement to the Small Business Deduction

Often, where professionals are partners of a partnership, they choose to carry out their professional services through a professional corporation ("PC"). The professionals would be employees of their PC and the professional services would be provided through the PC to the partnership as independent contractors. The professionals would continue to provide non-professional services to the partnership in their capacity as partners of the partnership. In the alternative, the assets of the partnership may be acquired by a newly created corporation ("Newco") and the professionals would provide their services as employees of their PC and the PCs would be independent contractors of Newco. The CRA has confirmed that each PC may access the small business deduction ("SBD"), provided the requirements to obtain the SBD are otherwise met (i.e., the PC is not a personal services business and the PCs are not associated with one another) whether the partnership or the Newco structure is used.

The CRA was asked to comment on a PC's ability to claim the small business deduction ("SBD") where a restriction is placed on the professional's right to compete. The CRA stated that it would consider whether the arrangement is conducted on an arm's length basis, including whether the fees charged for the services provided by the PCs would be the same as those charged by a professional who is not a partner or an employee. However, according to the CRA, where any of the terms of the arrangement between the PC and the partnership or between the PC and Newco bring into question the independent status of the professional, the ability of the PC to access the SBD is brought into question. The CRA has indicated that in these circumstances it will not provide an advance tax ruling regarding the availability of the SBD since such a determination could only be based on the actual conduct of the parties after the arrangements had begun. The CRA offered the following factors and conditions that it would expect before providing an advance income tax ruling:

- There are no restrictions (oral or otherwise) on the PC's or the professional's right to compete with the partnership, Newco or other PCs.
- Fees are based on the value of professional services rendered.
- Fees earned and paid to the PC are not based on the success of bill collection by the partnership or Newco in respect of the professional services provided by the PC.
- The professional is responsible for his or her own administrative services, library and supplies.

In the partnership context, it is not clear why the CRA has focused in on any restrictions on the professional's right to compete with the partnership as a factor that frustrates the ability of the PC to access the SBD. If the PC were

not used, and instead the professional services were provided directly to the partnership, the professional would be providing those services in his or her capacity as a partner and in no circumstance would the professional ever be considered an employee of the partnership.

– Document No. 2009-0315011E5, May 27, 2009

Qualified Farm Property

The taxpayer inquired whether there would be a deemed disposition pursuant to s. 45(1) where the use of real property changes from rental to the business of farming, such that the taxpayer would realize a capital gain. The CRA stated that since both uses are income earning purposes, there would be no deemed disposition of the property.

The taxpayer also inquired whether the property would be considered "qualified farm property" when the property is sold, and if so, whether it would be considered as such from the date of acquisition of the property, or from the date in which its use was converted to the business of farming. On this point, the CRA stated that land will be qualified farm property if it is used to carry on a farming business in Canada by the taxpayer, the taxpayer's spouse, parents, or children; or by a family farm partnership where any of the above persons owns an interest in the partnership. Furthermore, the property will be used in a farming business if the conditions in s. 110.6(1.3) are met. Whether this is the case is a question of fact. However, if the property does constitute qualified farm property and its use is changed from rental to the business of farming, the capital gain will be exempt for the entire period of ownership, not simply from the date on which the use was changed.

Finally, the CRA was asked whether the property could be bequeathed to the taxpayer's son on a tax-deferred basis. The CRA stated that it "allows a tax-free transfer of a deceased taxpayer's Canadian farm property to a child" so long as the child was resident in Canada immediately before the taxpayer's death and the property was used mainly in a farming business on a regular basis by the deceased parent or the deceased's spouse before the parent's death. For these purposes, land will meet this requirement if more than 50% of the land's area was used in the business of farming or where the property was used for farming for more than 50% of the years that the property was owned. If these conditions are met, the property will be transferred at the deceased's adjusted cost base such that no gain is realized. However, the deceased's legal representative may also choose a price between the adjusted cost base and the fair market value and realize some or all of the capital gain and the child will acquire the property at the amount chosen.

– Document No. 2009-0316191E5, May 27, 2009

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