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Tax and Family Business Succession Planning – What's News?

After many months of writing, I now have a copy of the third edition of *Tax and Family Business Succession Planning* actually sitting on my desk. Because it is in book form, the publication must be finalized about a month before printing is completed. This article will summarize several new developments that have occurred during this period. The fact that there has been some "news" in this time frame is not because of some unlucky confluence of events, but rather because the book covers a big chunk of tax and estate planning matters.

Control Premium: Cashing Out

One of the first things that occurred after we "put the book to bed" was that, in late September, the CRA announced an important change in its assessing policy in respect of the control premium issue.[1] It was stated that, in the context of an estate freeze of a CCPC, where a freezor, as part of the freeze, keeps controlling non-participating preference shares in order to protect his or her economic interest in the corporation, the CRA will generally ignore control premium for the purposes of the deemed disposition on death pursuant to subsection 70(5). We managed to sneak in an "insert" to the book on this, as well as a brief article in TAX NOTES.[2] However, after both of these were finalized, I got a call from a senior CRA official who enlightened me on what the CRA had in mind when it threw in the word "generally": the policy should not apply if the freezor continues to retain "thin-voting shares" after he or she has cashed-out of the freeze. As pointed out in the book, an example of this could be where the freeze shares are rolled into a holding company so that the shares can be redeemed without tax,[3] or if the redemption were "covered" by capital dividend and/or RDTOH balances.[4] Presumably, in these circumstances, there would be no "economic interest" left to protect.[5]

Although this is clear enough at first blush, when you think about it a bit, there are questions. For example, suppose that instead of redeeming out the freeze shares for cash, a promissory note is received (e.g., for asset protection). Hopefully, the CRA's view would be that the freezor would continue to have an "economic interest" to protect.

Inside

While the CRA statement is certainly welcome, and may suffice in a straight forward situation, its scope may be somewhat limited:[6] as I have previously pointed out, there is no indication that the administrative policy would apply to an *inter vivos* sale, e.g., where the position is taken that there is no control premium in order to maximize capital gains exemption claims, nor does it specifically pertain to exclusionary dividend share structures, e.g., where the founder of the business retains shares with voting rights as well as dividend rights which may allow the company to be stripped.

Associated Corporations and Trust Beneficiaries

The third edition of the book expands the discussion on the association rules and *inter vivos* trusts.[7] In a normal discretionary trust arrangement, each discretionary beneficiary is deemed to own all of the shares of the trust in accordance with subparagraph 256(1.2)(*f*)(ii). But when it comes to being a "beneficiary", how far does this go? Suppose, for example, that my family trust says that in the event my kids and grandkids all get nuked, the shares will go to, say, my third cousin in Vancouver. Is the aforementioned third cousin deemed to own the shares? In Question 11 of the 2008 APFF Round Table,[8] the CRA was asked about a person's status as a beneficiary, if entitled to receive shares under a default clause based on the provisions of an individual's will or laws of intestacy, which would be applicable if the primary beneficiaries were not alive or in existence. The CRA conveniently ducked the issue, but indicated that in its view, subsection 248(25), which contains the expanded concept of "beneficially interested", does not apply to subparagraph 256(1.2)(*f*)(ii).

This seemed to be supported in the recent *Propep* case,[9] in which the Tax Court of Canada 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).

However, the *Propep* case was very recently overturned by the Federal Court of Appeal.[10] Besides indicating that beneficiary status applied to the second ranking beneficiary because he was an income beneficiary and the trustees had the ability to wind-up the corporation in question, the case seems to indicate that, notwithstanding the consensus of most practitioners as well as the CRA, subsection 248(25), with its expansive meaning of "beneficially interested", does apply to the provisions in the association rules pertaining to beneficiaries.[11]

Residence of a Trust

Chapter 8 of the book discusses the choice of executors.[12] By way of introduction to this discussion, I mentioned the *Thibodeau Trust* case,[13] involving residence of trusts. My tax partner, Joan Jung, suggested that, in view of the rather sparse Canadian authority on this issue, I should include some comments on the CRA's position – that residence of a trust is based on the central management and control concept,[14] rather than the residence of the trustees *per se*. Notwithstanding my protestations that the mention of *Thibodeau* was somewhat peripheral to the discussion, I decided to add this material: I have found that following Joan's suggestions is a wise move.

Of course, just after the book was finalized, the *Garron* case[15] pertaining to the residence of trusts came out, specifically endorsing the central management and control test for trusts' residence (as well as the *Antle* case,[16] dealing mainly with the question of whether a trust was validly created). So if my remarks may seem somewhat prescient, it's not my doing. Because so much has been said about these cases – with a lot more to come as the fall goes on – I will not comment on them at this time, other than to say that I will find it extremely interesting to watch how trustees and tax planners cope with the decisions on both a go-forward basis and for existing files.[17]

– David Louis, tax partner, Minden Gross LLP, a member of MERITAS law firms worldwide. David's practice focuses on tax and estate planning for entrepreneurs and their corporations. dlouis@mindengross.com

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

PUBLICATIONS MAIL AGREEMENT NO. 40064546
RETURN UNDELIVERABLE CANADIAN ADDRESSES TO
CIRCULATION DEPT.
330–123 MAIN ST
TORONTO ON M5W 1A1
email circdept@publisher.com

90 Sheppard Ave. East, Suite 300
Toronto, Ontario M2N 6X1

Notes:

[1] British Columbia Tax Conference, September 22, 2009. The control premium issue is discussed at ¶227 of the book.

[2] No. 561, October 2009.

[3] This, of course, assumes that subsection 55(2) and Part IV tax do not apply. This is discussed at ¶204b of the book.

[4] See ¶202 of the book for further discussion.

[5] Of course, as I have pointed out in previous articles, thin-voting shares might also protect the ability to receive bonuses and control the destiny of the business; however, I gather that this doesn't count as an "economic interest" in the CRA's eyes.

[6] Besides deemed dispositions occurring pursuant to subsection 70(5) as specified in the statement, hopefully, it would also apply for other deemed dispositions on death (i.e., by a spouse, alter ego, or joint partner trust).

[7] See ¶319 of the book

[8] Doc. No. 2008-0285041C6, October 10, 2008.

[9] 2009 DTC 1163.

[10] 2009 CAF 274.

[11] The case has been reported only in French, so I am going on a computer translation. However, paragraph 24 appears to indicate that the application of subsection 248(25), is not dependent upon the actual use of the term "beneficially interested" in a particular provision.

[12] See ¶801a *et seq.* of the book.

[13] *Nicholas Bayard Dill and James Appleby Pearman, Trustees of the Thibodeau Family Trust, Plaintiffs, v. The Queen*, 78 DTC 6376 (FCTD).

[14] I.e., a trust is generally considered to reside where the trustee or other legal representative who manages or controls the trust assets resides.

[15] 2009 TCC 450.

[16] 2009 TCC 465.

[17] On a more technical note, in ¶223 of the book, it is mentioned that, in a situation where a trust subscribes for shares of a corporation and the corporation could potentially be a beneficiary of the trust, CRA Doc. No. 2006-0218501E5 indicates that the CRA has reversed its prior position and that it would not apply subsection 75(2) provided that the trust subscribed to shares for an amount equal to such shares' fair market value. Question 13 of the 2007 APFF Round Table (Doc. No. 2007-0243241C6, released on PROTOS® on October 14) extends this administrative largesse to apply to dividends paid on the shares or amounts received at the time of the acquisition or redemption of the shares.

Technical Changes to Tax-Free Savings Account Provisions

Reproduced below is Department of Finance News Release No. 2009-099, dated October 16, 2009, with accompanying backgrounder, concerning proposed amendments to the *Income Tax Act* with respect to Tax-Free Savings Accounts. Draft legislation was not released with the announcement.

The Honourable Jim Flaherty, Minister of Finance, today proposed amendments to the *Income Tax Act* to strengthen the rules applicable to Tax-Free Savings Accounts (TFSAs).

The TFSA was introduced in Budget 2008. Since January 1, 2009, Canadian residents who are 18 years of age or older are eligible to contribute up to $5,000 annually to a TFSA. The TFSA is a flexible, registered, general purpose account that allows Canadians to maximize their savings by earning tax-free investment income. Contributions to a TFSA are not tax-deductible, but investment income earned in a TFSA, as well as TFSA withdrawals, are tax-free.

The proposed amendments respond to recent concerns that have arisen regarding the use of TFSAs in tax-planning schemes.

The proposed amendments would:

- Make any income attributable to deliberate overcontributions and prohibited investments subject to existing anti-avoidance rules in the *Income Tax Act*.
- Make any income attributable to non-qualified investments taxable at regular income tax rates.
- Ensure that withdrawals of deliberate overcontributions, prohibited investments, non-qualified investments or amounts attributable to swap transactions, or of related investment income, from a TFSA do not create additional TFSA contribution room.
- Effectively prohibit asset transfer transactions between TFSAs and other accounts.

"These proposals will ensure that the TFSA remains viable and strong for Canadians today and in the future and the use of inappropriate transactions to draw excessive benefits are avoided," said Minister Flaherty.

As with the existing TFSA legislation, the Minister of National Revenue will maintain, in appropriate circumstances, the discretion to waive or cancel all or part of any tax that would otherwise be payable because of the application of today's proposals.

Given the clear intent of the TFSA concept, Minister Flaherty has asked the Honourable Jean-Pierre Blackburn, Minister of National Revenue, to ensure that the Canada Revenue Agency closely examines any unusual TFSA transactions that have occurred to date, and to apply the existing TFSA rules to challenge aggressive tax planning where appropriate.

The proposed amendments are to apply to transactions that occur after today. The Government will introduce legislation at an early opportunity.

* * *

Backgrounder

The Tax-Free Savings Account (TFSA) was introduced in Budget 2008. Since January 1, 2009, Canadian residents who are 18 years of age or older are eligible to contribute up to $5,000 annually to a TFSA. The TFSA is a flexible, registered, general purpose account that allows Canadians to maximize their savings by earning tax-free investment income. Contributions to a TFSA are not tax-deductible, but investment income earned in a TFSA, as well as TFSA withdrawals, are tax-free. Any amounts withdrawn from an individual's TFSA in a year will be added to the individual's contribution room for the following year.

The proposals announced today contemplate a number of amendments to the tax framework applicable to TFSAs. These amendments seek to address concerns regarding the use of TFSAs in tax-planning schemes.

Asset Transfer Transactions

"Asset transfer transactions" (sometimes known as "swap transactions"), in this context, refer to transfers of property (other than cash) for cash or other property between accounts (for example, a Registered Retirement Savings Plan (RRSP) and another registered account) that are generally not treated as a withdrawal and re-contribution, but instead as a straightforward purchase and sale. Subject to the application of existing anti-avoidance rules in the *Income Tax Act*, these transfers, when performed on a frequent basis with a view to exploiting small changes in asset value, could potentially be used to shift value from, for example, an RRSP to a TFSA without paying tax, in the absence of any real intention to dispose of the asset.

The proposed amendments would effectively prohibit asset transfer transactions between registered or non-registered accounts and TFSAs. The prohibition would apply to transfers effected between accounts of the same taxpayer or that of the taxpayer and an individual with whom the taxpayer does not deal at arm's length.

TFSA amounts that may reasonably be attributed to asset transfer transactions will be subject to the advantage rules in Part XI.01 of the *Income Tax Act*. The advantage rules are anti-avoidance rules that are applicable to transactions or events that would not have occurred in an open market in which parties deal with each other at arm's length and act prudently, knowledgeably and willingly. Where these rules apply, TFSA amounts reasonably attributable to asset transfer transactions will be taxable at 100%.

In circumstances where an asset transfer transaction were to occur inadvertently, after today, between a taxpayer's TFSA (or the TFSA of an individual with whom the taxpayer does not deal at arm's length) and another account, and the taxpayer promptly rectifies the situation by restoring each account to its position before the asset transfer transaction occurred, the Minister of National Revenue will have discretion to waive or cancel all or part of the tax payable, and the authority to adjust the taxpayer's TFSA contribution room accordingly. In such a case, the proposed amendment would provide for any investment income attributable to the asset transfer transaction to be taxed as regular income.

Deliberate Overcontributions

The TFSA rules allow a holder to contribute, for 2009, a maximum of $5,000. Contributions and associated earnings may accrue tax-free in the TFSA and may be withdrawn at any time without any adverse tax consequences. Contributions in excess of the contribution limit are subject to a tax of 1% per month on the highest amount of excess contributions for the month. This tax is generally sufficient to neutralize the tax benefit of overcontributions. The Government of Canada has become aware that in certain situations, and subject to the existing anti-avoidance rules in the *Income Tax Act*, some TFSA holders are attempting to generate a rate of return on deliberate overcontributions over a short period of time sufficient to outweigh the cost of the 1% tax. On its introduction, it was not anticipated that the TFSA would be subject to this type of deliberate overcontribution.

Under the proposed amendments, any income reasonably attributable to deliberate overcontributions will be made subject to the existing advantage rules (as described above) and taxed accordingly. Pursuant to the advantage rules, the tax payable on the income will be 100%.

The Minister of National Revenue will maintain the discretion to waive or cancel all or part of the tax payable and the authority to adjust the taxpayer's TFSA contribution room accordingly in appropriate circumstances.

Prohibited Investments and Non-Qualified Investments

A similar concern exists in relation to investment income related to prohibited investments and non-qualified investments held in TFSAs generally. The qualified investment regime sets out the basic investment framework for TFSAs (which is similar to the rules for RRSPs) and includes, for example, debt obligations issued by public corporations as well as publicly listed securities. The prohibited investment rules in respect of TFSAs are intended to guard against, for example, self-dealing opportunities for the holder. Prohibited investments include, for example, shares of the capital stock of a corporation in which the holder has a significant (10% or greater) interest and investments in entities with which the holder does not deal at arm's length. Non-qualified investments include, for example, land and general partnership units.

Under the current rules, where a TFSA holds a non-qualified investment or a prohibited investment, the holder of the TFSA is subject to a tax equivalent to 50% of the fair market value of the property. This tax is refundable to the holder if the investment is promptly disposed of from the account (by the end of the year following the year in which the tax arose, or such later time as the Minister of National Revenue considers reasonable), except in circumstances where the holder knew or ought to have known that the investment was non-qualified or prohibited. All or part of the tax may also be waived or cancelled at the discretion of the Minister of National Revenue where that Minister considers it just and equitable to do so having regard to the circumstances. Prohibited investments also trigger an additional income tax for the TFSA holder (equivalent to 150% of Part I tax in order to provide a proxy for the combined federal–provincial income tax rate) applicable to investment income earned on the prohibited investments. With respect to non-qualified investments, the trust governed by the TFSA is liable for income tax at regular federal/provincial rates on any investment income earned on non-qualified investments held inside the TFSA. The *Income Tax Act* does not provide for a similar Ministerial discretion to waive or cancel these additional taxes.

While the current TFSA regime applicable to prohibited investments and non-qualified investments provides for serious tax consequences for holding such investments, the investment income associated with the investments may remain tax-sheltered in the TFSA, resulting in an unintended permanent increase in TFSA savings and contribution room.

Under the proposed amendments, the existing prohibited investment tax framework will be modified so that any income reasonably attributable to prohibited investments will be considered an "advantage" and taxed accordingly, i.e. at 100%. The existing taxes on prohibited investment income will be repealed.

Further, any income reasonably attributable to non-qualified investments will also be taxable at regular federal/provincial income tax rates. That is, income earned on income that was earned on non-qualified investments will also be taxable. Under the existing rules, only the investment income on non-qualified investments is taxable as regular income and there is no obligation to remove these amounts. The proposed amendments ensure that the TFSA does not allow for the tax-sheltering of this ancillary income derived from non-qualified investments.

Withdrawals

The proposed amendments will also include rules to ensure that the withdrawal of amounts in respect of deliberate overcontributions, prohibited investments, non-qualified investments, asset transfer transactions and income related to those amounts do not constitute distributions for TFSA purposes and thus do not create additional TFSA contribution room.

Effective Date

It is proposed that these measures apply to transactions undertaken after today's date. Withdrawals of amounts related to transactions occurring on or before today's date will be governed by the existing rules.

Recent Technical Interpretations

Non-Arm's Length Transfer of Property

The CRA was asked whether money deposited in a joint bank account may be seized pursuant to s. 160 in particular circumstances where such a bank account is used to avoid collection of unpaid taxes. In these circumstances, the wife was the sole owner of a mortgaged waterfront property. Her husband, who owed outstanding taxes, was the sole income earner in the household and his earnings were deposited into a joint bank account each month. The mortgage payments on the waterfront property were made from that joint account.

Section 160 imposes liability on a transferee (wife) who has received property from a transferor (husband) indebted for an amount under the Act, including, pursuant to s. 160(1)(*e*) an imposition of joint and several liability on the transferee in respect of the transferor's tax debt up to the amount by which the value of the property transferred exceeds the fair market value of the consideration given by the transferee. In *Laframboise v. The Queen*, 2003 DTC 781, the Court held that a deposit in a joint bank account constitutes a transfer for the purposes of s. 160. The CRA stated that "in the absence of any agreement suggesting that the transferee is acting as agent on behalf of the transferor, the proposed s. 160 assessment would be supportable in law".

– Document No. 2008-0289281I7, August 12, 2009

Beneficial Ownership – Residential Property

CRA Rulings was asked by a Tax Services Office ("TSO") for its view on whether a person was the beneficial owner of a property.

The Taxpayer purchased and held legal title to a residence (the "Property"). The Taxpayer intended to help his Mother and Brother and would transfer the Property to them. For a time, the Taxpayer, his Mother and his Brother lived in the Property. Eventually, the Taxpayer moved out, and later the Mother was transferred to a seniors' home. Upon the Mother's death, the Brother listed the Property for sale and it was eventually sold.

The TSO's position was that, based on the absence of a trust agreement, the Taxpayer retained both legal and beneficial ownership of the Property, and thus any gain on the sale of the Property was attributable to the Taxpayer. The Taxpayer's view was that the Brother beneficially owned the Property.

"Beneficial owner" is not defined in the Act, and is used in the common law to distinguish the rights enjoyed by persons with a beneficial interest in property from those rights enjoyed by the legal title holder. Ruling's view is that possession, use and risk are the primary attributes of beneficial ownership (see IT-170R "Sale of Property – When Included in Income Computation", para. 8). Further, in the context of a principal residence, the right to transfer title of the property is a right that flows from beneficial ownership (see IT-437R "Ownership of Property (Principal Residence)", para. 4). The courts have stated that the beneficial owner is the "real or true owner" (see *Jodrey Estate v. Minister of Finance (Nova Scotia)*, 81 DTC 5344 (S.C.C.); and *Prévost Car Inc. v. The Queen*, 2008 DTC 3080 (T.C.C.), aff'd 2009 DTC 5053 (Fed. C.A.)). The determination of whether a person beneficially owned a property is a question of fact that requires a review of all documents and circumstances of a particular situation.

In the current situation, the Brother enjoyed all the attributes of ownership of the Property: he used the Property as his residence, retained the proceeds from the sale of the Property, and effected a transfer of the Property to the new owners. Further, the Brother maintained insurance in his name on the Property. The sale contracts and ancillary contracts for listing, financing and legal services on the sale were all in the name of the Brother.

The TSO's reliance on the absence of a trust agreement was not appropriate because such agreement would evidence only an intent to transfer beneficial ownership. The mere existence of a trust agreement in and of itself is not determinative of the question of whether a person beneficially owns a property.

Accordingly, Ruling's view was that the Brother and not the Taxpayer beneficially owned the Property.

– Document No. 2009-0324851I7, June 24, 2009

Home Renovation Tax Credit – Renovation of a Condominium

The situation the CRA was asked to review involved the renovation of a condominium by an individual. The CRA was asked which expenditures related to that renovation would qualify for the new home renovation tax credit. The CRA confirmed that the tax credit could be claimed for any eligible expenditures incurred to renovate the unit eligible as the individual's principal residence and in respect of expenditures incurred to renovate the common areas attributable to the individual.

– Document No. 2009-0312601M4, July 21, 2009

CCH a Wolters Kluwer business

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