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SELECTED TAX ISSUES AND TRAPS ASSOCIATED WITH ESTATE FREEZES

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This is the fourth instalment in a series of articles discussing issues and traps practitioners need to navigate to successfully implement and maintain an estate freeze. This article will review the corporate attribution rules in section 74.4 of the *Income Tax Act* (the "Act").[1]

The Corporate Attribution Rules

These rules are intended to deter income and capital gains splitting with "designated persons",[2] which might otherwise be achieved through direct or indirect loans or transfers of property by an individual to a corporation; and they do so by giving rise to deemed income inclusions in the hands of the lender or transferor, as the case may be.

Estate freezes need to be carefully designed to avoid these rules. The bad news is that, unchecked, these rules can significantly undermine the benefits of an estate freeze. This is because the deemed income inclusion can create double taxation, since it will only result in tax in the freezor's hands and will have no impact on the frozen corporation or its other shareholders. The good news is that with careful planning, it is generally possible to implement estate freezes without going offside of these rules or to make their negative effects manageable.

Prerequisites to Application — The Preamble to Subsection 74.4(2)

The rules are quite complex but, in general, they will not apply unless it can first be established that there has been a direct or indirect loan or transfer of property by an individual to a corporation where one of the main purposes of the loan or transfer can reasonably be considered to have been to reduce the income of the individual and to directly or indirectly benefit a designated person.

The reduction of income of an individual has generally been accepted to include the reduction not only of ongoing income but also of an individual's potential future capital gains and death tax exposure. As to the concept of transfer, it has generally been accepted to be broad enough to apply to most standard forms of estate freezes implemented under any of sections 51, 85, or 86. It is also possible that these rules could catch intercorporate freezes (sometimes called downstream or reverse freezes), even in situations where an individual had transferred property to the freezor corporation many years previously.[3]

Personally, I have found that the application of section 74.4 can pose some significant challenges in situations where both spouses are pre-existing shareholders of a corporation that is to be reorganized as part of implementing an estate freeze.[4] Based on my experience, it is often quite difficult to eliminate these risks, but with care and attention, the exposure can often be minimized.

Further Conditions for Application

If the prerequisite for applying subsection 74.4(2) is met, then the corporate attribution rules will apply to any period or periods in a taxation year throughout which each of the following conditions applies:

(1) The designated person, whether he or she is a resident of Canada, is a "specified shareholder" of the corporation — which means that he or she has or is deemed to have more than 10% of the shares of any class of the corporation, and for this purpose, a discretionary beneficiary of a trust is generally deemed to own all of the shares held by the trust;[5]

(2) The transferor is a resident of Canada; and

(3) The corporation was not a small business corporation ("SBC").[6]

Generally, in a freeze situation the first two conditions will be satisfied. As a result, in most cases the only way to avoid section 74.4 will be to ensure that the corporation is an SBC at all times. Unfortunately, constantly maintaining a corporation's status as an SBC is often difficult, if not impossible, and as a result, attempting to avoid the corporate attribution rules based on SBC status can be risky.

Fortunately, there are other ways to avoid the application of the corporate attribution rules, and I'll comment on some of the ways to do this following a brief discussion of the calculation of how the corporate attribution income inclusion operates.

Computation of the Benefit

The periodic nature of the corporate attribution rules and certain technicalities in their drafting can make calculating the benefit quite tricky. In essence, the deemed income inclusion benefit of the lender or transferor for any particular period will be determined by multiplying the "outstanding amount"[7] of the loan or transfer by the prescribed rates in effect during that particular period. The outstanding amount is a complex concept that contemplates the ability to repay loans and to reduce the amount of the transfer under certain circumstances.

Once this income inclusion amount is determined, it will be reduced in the event that the lender or transferor actually received interest or dividends in the year[8] in respect of the loans or shares to which the corporate attribution rules would have otherwise applied. However, dividends deemed to have been received under section 84, for example, on share redemptions, will not reduce the income inclusion in any particular period.

Avoiding the Application of Section 74.4

Although paying interest or dividends on loans or shares may offer a relatively easy solution to the corporate attribution rules, particularly at today's low prescribed rates, in order to maximize the benefits of estate freezing, interest is often not paid on loans made by a freezor and dividends are often not paid on the freezor's frozen shares. Instead, reliance is often placed on section 74.4 not being applicable in the first place — for example, because the corporation is at all times an SBC, which, as I mentioned previously, may be a risky thing to do.

The Subsection 74.4(4) Exception

As an alternative, if neither of the options described above is available, planners should take steps to ensure that the freeze is implemented in compliance with the exception to the corporate attribution rules provided in subsection 74.4(4).

Subsection 74.4(4) deems all loans or transfers to a corporation *not* to have been made to benefit a designated person, provided that:

(1) The only interest of the designated person in the corporation is a beneficial interest in shares of the corporation held by the trust;

(2) By the terms of the trust, while an individual is a designated person, he or she can't obtain any benefit from the income or capital of the trust; and

(3) While the individual is a designated person, he or she must not obtain any actual benefit from the income or capital of the trust.

In order to comply with this provision, most practitioners will include an "anti-74.4" clause in their trusts that clearly complies with these requirements.

Unfortunately, while such clauses address the corporate attribution rules, the clauses may considerably restrict the benefits of estate freezing, particularly if capital gains exemption multiplication with minors or spouses is a motivating factor in entering into the freeze in the first place.

Stock Dividend Planning

It is generally accepted that the payment of dividends does not constitute a transfer to a corporation by its recipient shareholder.[9] Consequently, in appropriate situations it may also be possible to avoid the corporate attribution rules by using high-low stock dividends, which involve the issuance of shares with significant value but very little paid-up capital, to implement freezes and for other forms of planning. However, planning with stock dividends appears to have other possible risks associated with it, including the possible application of the general anti-avoidance rule in subsection 245 in some cases.

Notes:

[1] Unless otherwise noted, all statutory references are to the Act.

[2] Per subsection 74.5(5), a designated person is an individual's spouse or a non-arm's length minor, including a nephew or niece.

[3] See subsection 74.5(6). For more on this topic, see Paul W. Festeryga, "Corporate Attribution: The 'Anti-Freeze' Rule" in "Personal Tax Planning," (2010) *Canadian Tax Journal* vol. 58, no. 3, 675-696 at 681.

[4] Spouses will be designated persons in respect of one another.

[5] See the definition of "specified shareholder" in subsection 248(1).

[6] As that term is defined in subsection 248(1).

[7] As that term is defined in subsection 74.4(3).

[8] Certain amounts included in the "split income" of a "designated person" will also reduce the income inclusion amount. For more information on these defined terms, please see Part III of this series of articles in issue no. 603 of *Tax Notes* (April 2013).

Interestingly, the language in paragraphs 74.4(2)(*e*) and (*f*) does not provide the 30-day grace period available in respect of the personal attribution rules in sections 74.1 and 74.2 and subsection 56(4.1) (for more on the personal attribution rules, please see Part II of this series of articles in issue no. 602 of *Tax Notes* (March 2013)). As such, it would seem that any interest or dividend amounts that are received by the lender or transferor at any time after the end of the year will not reduce the deemed income inclusion under the corporate attribution rules.

[9] See *Algoa Trust et al. v. The Queen*, 93 DTC 405.

SUPREME COURT OF CANADA — APPLICATIONS FOR LEAVE TO APPEAL DISMISSED

On April 11, 2013, the Supreme Court of Canada dismissed with costs the application for leave to appeal in the case of *Canada v. Global Equity Fund Ltd.*, 2013 DTC 5007 (FCA). The case concerned a corporate taxpayer's series of transactions undertaken with an initially stated overarching motive to gain protection from potential creditors; these transactions simultaneously created a non-capital loss that was used to offset prior years' tax payable. The Tax Court of Canada agreed with the Minister's reassessment and denied the capital loss on the basis of the general anti-avoidance rule ("GAAR"). The Federal Court of Appeal ("FCA") affirmed the Tax Court's decision, holding that GAAR would be applied as the transactions were undertaken to create an artificial business loss for the purpose of avoiding taxes owed on profits from real-world business operations. However, because the Crown presented "ever changing" arguments and positions regarding GAAR during the proceedings, the FCA determined the taxpayer was entitled to costs.

On March 28, 2013, the Supreme Court of Canada dismissed the application for leave to appeal in the case of *1207192 Ontario Limited v. The Queen*, 2012 DTC 5157 (FCA). The case concerned a corporate taxpayer's series of transactions that sought to gain protection from potential creditors; these transactions simultaneously created a capital loss that was used to offset capital gains. The Tax Court of Canada agreed with the Minister's reassessment and denied the capital loss on the basis of GAAR. The Federal Court of Appeal affirmed the Tax Court's decision, holding that GAAR would be applied as one or more transactions were undertaken to obtain a tax benefit and the creditor protection objective could have been achieved without creating a capital loss.

PROVINCIAL INCOME ALLOCATION CALCULATIONS: TAXABLE BENEFITS

On April 10, 2013, the Canada Revenue Agency ("CRA") released the March 2013 issue of its *Provincial Income Allocation* newsletter, No. 4. Reproduced below is the new position of the Allocation Review Committee regarding taxable benefits and their inclusion in provincial income allocation calculations, effective for the 2013 tax year.

> The issue is whether all taxable benefits that are included in calculating an employee's income for the year, such as a stock option benefit under section 7 of the *Income Tax Act* (the Act), are also included in "salaries and wages paid in the year" to employees for the purpose of the provincial income allocation calculations in the *Income Tax Regulations* (the Regulations).
>
> One example of the allocation calculation is in subsection 402(3) of the Regulations. This provision determines the amount of a corporation's taxable income for the year that is allocated to a particular province when a corporation has a permanent establishment in that particular province in a tax year, and a permanent establishment outside that province. The taxable income is generally allocated to a particular province based on the proportion of the corporation's gross revenue for the year that is attributable to the permanent establishment in the province, and the proportion of the corporation's salaries and wages paid in the year to employees of that permanent establishment. Historically, the Allocation Review Committee (ARC)[1] agreed that any taxable benefits that are not deductible in calculating the employer's income should be excluded from salaries and wages paid in the year for provincial income allocation purposes.
>
> ARC's position on this matter has changed. Effective for the 2013 tax year, the amount of salaries and wages paid in the year for the purpose of the provincial income allocation calculations will include all taxable benefits that are to be included in the employees' income in the year. This includes deemed amounts such as stock option benefits under section 7 of the Act, regardless of whether these benefits are deductible in calculating the employer's income.

Notes:

[1] The members of the ARC include tax administrators from Alberta, Québec, Ontario and the Canada Revenue Agency (CRA) on behalf of the provinces and territories with which the CRA has tax collection agreements.

INTRODUCTION OF INCOME TAX FOLIOS

On March 28, 2013, the Canada Revenue Agency (the "CRA") released the first publications in its new Income Tax Folios series. This new series of publications will incorporate, update, and replace material contained in CRA tax interpretation bulletins and in *Income Tax Technical News*. The purpose of the Income Tax Folios, like that of their predecessors, will be to provide technical interpretations and set out administrative positions regarding specific income tax provisions.

Each individual folio will be subdivided into topic-specific chapters, and the folios themselves will be broadly categorized into seven series. Folios intended to be released include the following:

- Series 1 — Individuals
  - Folio 1: Health and medical; Folio 2: Students; Folio 3: Family unit issues; Folio 4: Personal credits; Folio 5: Transfers of income, property, or rights to third parties; and Folio 6: Deceased individual
- Series 2 — Employers and Employees
  - Folio 1: Specific plans offered by employers to employees; Folio 2: Deductions from employment income; Folio 3: Employment benefits; and Folio 4: Information specific to particular fields of employment
- Series 3 — Property, Investments, and Savings Plans
  - Folio 1: Shares, shareholders & securities transactions; Folio 2: Dividends; Folio 3: Capital transactions; Folio 4: Capital cost allowance; Folio 5: Eligible capital property; Folio 6: Interest; Folio 7: Real estate or rental properties; Folio 8: Resource properties; Folio 9: Miscellaneous payments/receipts; Folio 10: RRSPs; and Folio 11: Transfers between registered plans

- Series 4 — Businesses
  - Folio 1: General business concepts; Folio 2: Deducting business expenses; Folio 3: General principles of business income calculation; Folio 4: Corporations — status & structures; Folio 5: Tax-deferred rollovers; Folio 6: Provisions applicable to specific corporations; Folio 7: Wind-ups, dissolutions, and amalgamations; Folio 8: Losses; Folio 9: Bad debts & debt forgiveness; Folio 10: Inventory; Folio 11: Farmers; Folio 12: Contractors & construction; Folio 13: Income from professional practices; Folio 14: Income from artistic endeavours; Folio 15: Manufacturing and research & development; and Folio 16: Partnerships
- Series 5 — International and Residency
  - Folio 1: Residency; Folio 2: Foreign tax credits and deductions; and Folio 3: Cross-border issues
- Series 6 — Trusts
  - Folio 1: Trusts and residency issues; Folio 2: Beneficiaries; Folio 3: Taxation of an *inter vivos* trust and attribution; and Folio 4: Testamentary trusts
- Series 7 — Charities and Non-Profit Organizations
  - Folio 1: Charitable donations and deductions; and Folio 2: Non-profit organizations

Issuance of these Folios by the CRA is expected to take place over a number of years. In its initial release, the CRA has published the following folio chapters in consultation draft format. Each of these consultation drafts is effective March 28, 2013 and all are open for comment for a period of three months, until June 28, 2013. Recommendations by the public on the content or structure of these chapters may be sent directly to the CRA at folios@cra-arc.gc.ca.

- Series 1 — Individuals, Folio 1: Health and Medical
  - **S1-F1-C1, Medical Expense Tax Credit** — This chapter discusses eligibility requirements, calculation, and qualifying expenses for the purposes of the medical tax credit and refundable medical expense supplement. This chapter, together with the following two folio chapters, replaces Interpretation Bulletin IT-519R2, Medical Expense and Disability Tax Credits and Attendant Care Expense Deduction.
  - **S1-F1-C2, Disability Tax Credit** — This chapter discusses eligibility requirements, calculation of amounts, circumstances of transferability, and certification and filing requirements of the disability tax credit and disability tax credit supplement.
  - **S1-F1-C3, Disability Supports Deduction** — This chapter discusses eligibility requirements, qualifying expenses, and calculation of the disability supports deduction.
- Series 1 — Individuals, Folio 2: Students
  - **S1-F2-C1, Education and Textbook Tax Credits** — This chapter provides an extensive review of education and textbook tax credit provisions and replaces Interpretation Bulletin IT-515R2, Education Tax Credit.
  - **S1-F2-C2, Tuition Tax Credit** — This chapter provides an extensive review of the tuition tax credit provisions and replaces Interpretation Bulletin IT-516R2, Tuition Tax Credit.
  - **S1-F2-C3, Scholarships, Research Grants and Other Education Assistance** — This chapter discusses the taxation of scholarships, fellowships, bursaries, prizes, research grants, government financial assistance, forgivable loans, and repayable awards, and consolidates and replaces Interpretation Bulletins IT-75R4, Scholarships, Fellowships, Bursaries, Prizes, Research Grants and Financial Assistance, IT-340R, Scholarships, Fellowships, Bursaries and Research Grants — Forgivable Loans, Repayable Awards and Repayable Employment Income, and IT-340SR.
- Series 1 — Individuals, Folio 3: Family Unit Issues
  - **S1-F3-C1, Child Care Expense Deduction** — This chapter discusses qualifying expenses for the purposes of the child care expense deduction, as well as eligibility requirements and claim limitations, and provides examples of deduction calculations. It replaces Interpretation Bulletin IT-495R3, Child Care Expenses.
  - **S1-F3-C2, Principal Residence** — This chapter discusses the principal residence capital gains exemption and consolidates and replaces Interpretation Bulletins IT-120R6, Principal Residence, and IT-437R, Ownership of Property (Principal Residence).

- Series 4 — Businesses, Folio 3: General Principles of Business Income Calculation
  - **S4-F3-C1, Price Adjustment Clauses** — This chapter discusses the use, requirements, and consequences of price adjustment clauses commonly used in agreements between non-arm's length parties to avoid negative tax consequences as a result of fair market value determinations and replaces Interpretation Bulletin IT-169, Price Adjustment Clauses.
- Series 5 — International and Residency, Folio 1: Residency
  - **S5-F1-C1, Determining an Individual's Residence Status** — This chapter sets out the CRA's administrative position on factors to be taken into account in the determination of an individual's residency status and replaces Interpretation Bulletin IT-221R3, Determination of an Individual's Residence Status.
- Series 5 — International and Residency, Folio 2: Foreign Tax Credits
  - **S5-F2-C1, Foreign Tax Credit** — This chapter provides CRA interpretations of some of the common requirements of the foreign tax credit provisions and replaces Interpretation Bulletins IT-270R3, Foreign Tax Credit, IT-395R2, Foreign Tax Credit — Foreign-Source Capital Gains and Losses, and IT-520 (Consolidated), Unused Foreign Tax Credits — Carryforward and Carryback.

Effective September 30, 2012 and in connection with the arrival of the Income Tax Folios, the CRA has cancelled archived income tax interpretation bulletins, all archived *Income Tax Technical News*, and nine other income tax interpretation bulletins.

Published Folio chapters listed above are available on CCH's News Tracker. New and revised folios will continue to be posted to News Tracker as they are released and will be added to CCH's federal tax libraries.

CRA'S FIRST-TIME DONOR'S SUPER CREDIT

The March 21, 2013 federal Budget contained a proposal for a temporary supplement to the non-refundable charitable donations tax credit for individuals. The proposed new credit could be claimed once from the 2013 to 2017 taxation years. Reproduced below is a set of questions and answers released by the Canada Revenue Agency on April 2, 2013 regarding the proposed First-Time Donor's Super Credit.

Q1. How is the existing non-refundable tax credit for charitable donations calculated?

A1. Currently, the non-refundable charitable donations tax credit (CDTC) is calculated as the total of:

- the lowest income tax rate (15% for 2013) multiplied by the first $200 of charitable donations claimed by an individual; and
- the highest income tax rate (29% for 2013) multiplied by the portion of the donations claimed by the individual that exceeds $200.

Q2. What is the new First-Time Donor's Super Credit (FDSC)?

A2. Starting in the 2013 taxation year, the budget proposes to introduce a temporary non-refundable FDSC that will supplement the CDTC for individuals. This new credit effectively adds 25% to the rates used in the calculation of the CDTC for up to $1,000 of monetary donations. As a result, a first-time donor will be allowed a 40% federal credit for donations of $200 or less, and a 54% federal credit for the portion of donations over $200 but not exceeding $1,000.

Example 1: An eligible first-time donor claims $500 of charitable donations in 2013. All of the donations are donations of money. The first-time donor's FDSC and CDTC would be calculated as follows:

First $200 of charitable donations claimed:	$200 × 15% =	$30
Charitable donations claimed in excess of $200:	$300 × 29% =	$87
First-Time Donor's Super Credit:	$500 × 25% =	$125
Total FDSC and CDTC:		**$242**

Example 2: An eligible first-time donor claims $700 of charitable donations in 2013. Only $300 of the donations are donations of money. The first-time donor's FDSC and CDTC would be calculated as follows:

First $200 of charitable donations claimed:	$200 × 15% =	$30
Charitable donations claimed in excess of $200:	$500 × 29% =	$145
First-Time Donor's Super Credit:	$300 × 25% =	$75
Total FDSC and CDTC:		**$250**

Q3. When can I claim the FDSC?

A3. As the FDSC is a temporary credit, you can only claim it once from the 2013 to 2017 taxation years.

Q4. Who is considered a first-time donor?

A4. For the 2013 taxation year, an individual will be considered a first-time donor if neither the individual nor the individual's spouse or common-law partner has claimed the CDTC in any of the five preceding tax years.

Q5. Can both my spouse or common-law partner and I claim the FDSC?

A5. As a first-time donor, the FDSC, along with the corresponding CDTC, may be shared by you and your spouse or common-law partner in a particular taxation year. However, the total amount of donations that may be claimed for the FDSC by both individuals cannot exceed $1,000. When it cannot be agreed on the amount of the credit that each of you will claim, the CRA may apportion the credit.

Q6. Do all of my donations qualify for the FDSC?

A6. No. Only donations of money that are made after March 20, 2013 will qualify for the FDSC. For taxation years from 2013 to 2017, a new line will be added to Schedule 9, *Donations and Gifts*, to identify the eligible portion of the charitable donations that you have claimed that are donations of money.

Q7. Where can I get more information about the FDSC?

A7. The CRA is committed to providing taxpayers with up-to-date information. The CRA encourages taxpayers to check its Web site often. All new forms, policies, and guidelines will be posted as they become available.

CRA'S SCIENTIFIC RESEARCH AND EXPERIMENTAL DEVELOPMENT PROGRAM

The March 21, 2013 federal Budget contained a proposal to expand information requirements and introduce new penalty provisions to the scientific research and experimental development tax incentive program. The proposed changes would apply to claims filed on or after the later of January 1, 2014 and the date of Royal Assent of the enacting legislation. Reproduced below is a set of questions and answers released by the CRA on April 10, 2013 regarding these proposed changes.

To access SR&ED tax incentives, *Form T661, Scientific Research and Experimental Development (SR&ED) Expenditures Claim*, must be completed and submitted to the CRA by the reporting deadline. Taxpayers are currently requested to only provide limited information to the CRA about the external consultants that prepared certain parts of their SR&ED tax incentive program claim.

For claims filed on or after the later of January 1, 2014, and the date of Royal Assent, the budget announces that the CRA will require additional prescribed information in respect of tax preparers (including external consultants) who have assisted with the preparation of an SR&ED tax incentive program claim. The budget also proposes to introduce a penalty in respect of each SR&ED tax incentive program claim if prescribed information is missing, incomplete or inaccurate.

Q1. What information is currently requested on Form T661 in respect of the preparers that assisted in the preparation of an SR&ED tax incentive program claim?

A1. Currently, the taxpayer is only required to provide the name (or the firm's name) of the external consultant that prepared the response for section B or section C of Part 2 of Form T661 and the name of the person or firm who completed Form T661.

Q2. What additional prescribed information will be requested on Form T661 in respect of the preparers that assisted in the preparation of an SR&ED tax incentive program claim?

A2. Form T661 will be revised to require the business number of each preparer and details about the billing arrangements, including whether contingency fees were used and the amount of the fees payable. In instances where no preparer was involved, the taxpayer will be required to certify that no preparer assisted in any aspect of the preparation of the SR&ED tax incentive program claim.

Q3. What is the amount of the new penalty that will be applied if prescribed information is missing, incomplete or inaccurate?

A3. The budget proposes to introduce a penalty of $1,000 in respect of each SR&ED tax incentive program claim made by a taxpayer for which prescribed information in respect of the preparation is missing, incomplete or inaccurate.

Q4. Who will be liable for the new penalty?

A4. Where a preparer participates in the preparation of an SR&ED tax incentive program claim, the taxpayer and the preparer will be jointly and severally, or solidarily, liable for the penalty.

Q5. Where can I get more information about the changes to the SR&ED tax incentive program?

A5. The CRA is committed to providing taxpayers with up-to-date information. The CRA encourages taxpayers to check its Web site often. All new forms, policies, and guidelines will be posted as they become available.

In the meantime, please see the Department of Finance Canada's Budget 2013 documents for details.

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