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Succession Planning – Intergenerational Cash-Outs

Note: This article is adapted from the soon-to-be-published third edition of *Tax and Family Business Succession Planning*, by David Louis, Samantha Prasad and new co-author Michael Goldberg[1] (CCH Canadian Limited).

While the cornerstone of family business succession planning is the estate freeze,[2] in some cases, it may be desired that the founder of the business be paid for his or her interest, within a freeze structure (usually by liquidating the freeze shares) or otherwise. If so, there are special opportunities to defer tax on an intergenerational cash-out within a family, which are not available in respect of third-party sales.

Ten-Year Reserve for Intergenerational QSBC Share Transfer[3]

Per subsection 40(1.1) of the Act, the normal five-year reserve is extended to ten years, where qualifying small business corporation shares are transferred to a Canadian-resident child or grandchild,[4] so that the minimum rate of recognition of the gain i s 10% per year.[5] (Qualifying small business corporation shares are discussed in Chapter 4 – these are shares which are eligible for the $750,000 capital gains exemption, and generally include freeze shares.)

To qualify for the ten-year reserve, the transferee of the shares must be the child or grandchild. This appears to rule out a transfer of a qualifying corporation by a taxpayer's holding company or other indirect transfer. Likewise, it appears that the intergenerational transfer would not be available to a spouse, alter ego or joint partner trust. However, if shares were left outright to a spouse or common-law partner (or an encroachment consisting of the shares from the aforementioned trusts), the reserve would be available if the surviving spouse effected an otherwise-qualifying intergenerational transfer. Also, there is no provision for a transfer to a trust in favour of such individuals, or to a holding company.

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However, since there is no holding period requirement, there appears to be no reason why the child or grandchild could not roll the shares into a holding company (in fact, this may be advantageous – see below).

The reserve on the unrecognized gain will be taxed on death,[6] but effectively can be "rolled over" to a surviving spouse or qualifying spouse trust.[7] While claiming the subsection 40(1.1) reserve will, of course, accelerate tax, the provision can nevertheless be quite useful in the right circumstances. One example, of course, is where "the business deal" is that there be an *inter vivos* sale of shares to a child or grandchild. It should also be noted that, notwithstanding the reserve, the transferee would presumably obtain a full cost base in the shares. Unless a reserve was claimed in connection with a capital gains exemption claim,[8] the ability to use the cost base to access the corporation's assets on a tax-efficient basis will not be blocked by section 84.1. Therefore, it appears that (subject to possible GAAR considerations) the transferee could use the increased cost base to access corporate level assets on a tax-efficient basis, e.g., by transferring his or her shares to a Holdco.[9]

Finally, it should not be forgotten that qualifying small business corporation shares may also qualify for the $750,000 lifetime capital gains exemption, which can be used in combination with the 10-year reserve discussed above.

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Integenerational Corporate Cash Out[10]

Another tax-effective way for the Freezor to exit from the operating structure could involve Freezor transferring his or her frozen Opco shares to a Holdco on a tax-deferred basis and then causing Opco to redeem the frozen shares held by Holdco. This planning would permit Holdco to invest the redemption proceeds in such manner as Freezor desired without leaving the assets subject to creditors of Opco.

Provided that the frozen corporate group is comprised solely of related persons[11] inter-corporate redemptions will generate deemed dividends, which should not be subject to recharacterization as capital gains under subsection 55(2).[12] Also, although it may be possible to redeem all of the Freezor's shares from the outset of the transaction, for corporate reasons,[13] this may not be practical and, in addition, without careful planning, in some situations a full inter-corporate redemption may reduce the effectiveness of pre- and post-mortem planning strategies intended to enable Freezor to minimize his or her death taxes.[14]

Rather than roll all of the freeze shares into a Holdco, one obvious variation is to retain sufficient freeze shares to utilize Freezor's capital gains exemption through an *inter vivos* sale, or on death.

Special Opportunities from Eligible Dividends[15]

Where Opco has generated GRIP, the benefits may be enhanced by designating the deemed dividend as an eligible dividend out of GRIP, so that future dividends from Holdco to Freezor may qualify for lower tax rates. (It should be noted that the combined corporate/personal tax when income is taxed at full corporate tax rates and distributed as an eligible dividend is generally more or less equal to the tax that would be incurred had the income been earned directly by an individual, so this process will ultimately be largely tax-efficient. But until earnings are distributed to the individual shareholder as eligible dividends, there will be a significant element of tax deferral, so that the foregoing arrangement is quite beneficial where Freezor is cashing out.)

Of course, the ability of Freezor to cash out on a tax-efficient basis could be important if there are special cash requirements resultant from disability. In this and other cases where subsection 55(2) has not applied, the proceeds of the inter-corporate redemption will presumably be invested at the Holdco level, so as to preserve the deferral. The investment income may well generate RDTOH, with the earnings periodically distributed to fund personal and living expenses. In this case, the availability of GRIP – i.e., which may be resultant from the deemed dividend from the intercorporate redemptions between Opco and Holdco – will enable the dividend from Holdco to trigger a dividend refund, yet still maintain its status as an eligible dividend. [16]

The 3rd Edition of *Tax and Family Business Succession Planning* may be ordered on the CCH website at www.cch.ca, or by Googling "Tax and Family Business Succession Planning".

Notes:

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[2] Rather than simply selling or gifting the shares of a corporation, for example, to the next generation, an estate freeze allows the owner-manager to set up a structure whereby the children are brought into the corporation (either directly or through a trust) without generating adverse tax consequences, while effectively freezing the value of the owner-manager's interest in the corporation at the time of the estate freeze, thereby limiting his or her tax liability on death.

[3] This material appears in Chapter 2, at ¶204a.

[4] See subsections 40(8) and 70(10).

[5] The deferral is also available in respect of qualifying farming and fishing transfers. If the sale is in consideration for a demand promissory note, it is prudent to insert a time lag prior to the expiration of which the note will not be payable. The possible application of section 69 should also be considered.

[6] See subsection 72(1).

[7] See subsection 72(2).

[8] Very basically, where the taxpayer or a non-arm's length person has claimed the capital gains reserve, for the purpose of computing the cost base for the purpose of section 84.1 (often referred to as the "84.1 cost base"), subsection 84.1(2.1) is designed to treat the transferor as if the maximum capital gains exemption had been claimed and no reserve had been taken.

[9] Because the shares must be qualifying small business corporation shares, one would not expect there to be significant surplus assets in the particular corporation (initially at least). The cost base might be used to access liquid assets of other corporations; however, this would result in a situation reminiscent of *Desmarais v. The Queen*, 2006 DTC 2376 (T.C.C.), in which the taxpayer was successfully attacked under GAAR.

[10] This material appears in Chapter 2, at ¶204b.

[11] It is, however, critical that the exception to subsection 55(2) in paragraph 55(3)(*a*) apply; this should be reviewed carefully. For purposes of section 55, the concept of related persons is modified by subsection 55(5). Of particular importance is that pursuant to subparagraph 55(5)(*e*)(i) siblings are deemed to be unrelated persons. Also, pursuant to subparagraph 55(5)(*e*)(ii) a person who is related to every beneficiary of a trust (other than a registered charity) who is or may (otherwise than by reason of the death of another beneficiary of the trust) be entitled to share in the income or capital of the trust is deemed to be related to the trust. Based on the foregoing, it may well be the case that in a properly implemented estate freeze, the trust and Opco will be related.

The introduction of Holdco into the structure requires further analysis, but happily it appears that, provided that the Holdco is an existing Holdco controlled by Freezor or a new Holdco of which Freezor is the incorporator and controlling shareholder, it should be possible to structure the planning so that Holdco will also be a related person. For more on this subject see CRA document numbers 970045 and 9626315, both dated July 7, 1998, as well as Vance Sider, CA and Marc Ton-That, CA *Understanding Section 55 and Butterfly Reorganizations* 1999, CCH Canadian Limited at page 90. Notwithstanding concerns raised by Sider and Ton-That, it appears that proposed amendment to clause 55(3)(*a*)(iii)(B) should also permit this problem to be solved where a shelf corporation is used (see Ted Citrome, "An Introduction to Paragraph 55(3)(*a*)", *Report of Proceedings of Fifty-Eighth Tax Conference*, 2006 Tax Conference (Toronto: Canadian Tax Foundation, 2007), 36:1-31 footnote 66).

[12] Part IV tax would apply if Opco obtains a dividend refund.

[13] For example, a redemption of all of the shares would almost certainly cause Opco to have to report significant deficits on its balance sheet, which might either preclude obtaining financing or might violate covenants in existing financial relationships. There may be ways of dealing with such issues, but these are beyond the scope of this discussion.

[14] For example, if Opco subsequently generates GRIP balances, depending on the structure used, there may be no effective way for Holdco to access such balances.

[15] The material appears in Chapter 11, at ¶1107, "Buy-sell options for liquidity events within the family."

[16] This could be even more effective in respect of distributions to individual shareholders than the application of subsection 55(2) which, may substantially tax-pay a distribution to an individual. For further discussion, with particular reference to disability issues, see "Selected Aspects of Buy-Sell Provisions", Walter Benzinger, Doris Trevisani, and Karen Wilkinson, 2006 CR 35:1.

Control Premium – CRA Changes Policy on Freezes

At the British Columbia Tax Conference, the CRA had welcome news in respect of its assessing policy on the control premium issue. 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[1] ignore control premium. This is notwithstanding Income Tax Technical News No. 38[2] in which the CRA indicated that "a hypothetical purchaser would be willing to pay some amount for voting control of a company".

The CRA response is reproduced below.[3] It should be noted that it did not specifically address control premium for so-called exclusionary dividend structures, such as those used for dividend splitting or capital gains exemption multiplication.[4] Also, the policy is applicable "for the purposes of subsection 70(5)" – i.e., the deemed disposition on death; no mention is made of an *inter vivos* sale.

> As stated in Income Tax Technical News No. 38, the CRA does not have an established position on valuing different types of property, including shares, as the valuation is dependent on the facts and circumstances of each situation. Information Circular 89-3 (IC 89-3), Policy Statement on Business Equity Valuations, outlines the valuation principles and policies that the CRA considers and follows in the evaluation of securities and intangible property of closely held corporations for income tax purposes. In determining the fair market value of a class of shares, the CRA determines the fair market value of the corporation "as a whole" or "en bloc" and then allocates the value to each class of shares in isolation. The fair market value of each class is determined according to the rights and restrictions of each class and voting control is a right that may have significant value.
>
> The CRA's position is that non-participating controlling shares have some value and may therefore bear a premium. However, in the context of an estate freeze of a Canadian-controlled private corporation, where the freezor, as part of the estate freeze, keeps controlling non-participating preference shares in order to protect

his economic interest in the corporation, the CRA generally accepts not to take into account any premium that could be attributable to such shares for the purposes of subsection 70(5) of the *Income Tax Act* at the freezor's death.

– David Louis, Minden Gross, Toronto (dlouis@mindengross.com). Thanks to William Cooper and Charles Pearson, Boughton, Vancouver

Notes:

[1] At the June STEP Conference, a senior CRA official alluded to "lowball" estate freeze valuations in the context of where it might be germane for the CRA to assert that control premium should apply. I am not aware of any specific mention of this situation at the BC Tax Conference. My personal feeling, however, is that if the CRA has a serious problem with a freeze valuation, arguing this issue may be more palatable than other avenues which might be used by the CRA to put a longstanding redemption value at issue.

[2] September 22, 2008.

[3] Among other things, the question asks whether the CRA is proposing to recommend that a premium be placed on new common shares issued after a freeze.

[4] As will be noted, the end of the first paragraph indicates that a voting control right may have "significant value".

Treaty Trumps Section 116 Withholding – Residence of a Trust Under a Treaty Requires Physical Nexus

In *Robert M.O. Morris and Neville Leroy Smith, Trustees of the RCI Trust v. M.N.R.*, 2009 DTC 5127, the Federal Court reached two noteworthy conclusions: i) a treaty overrides the withholding tax requirements under section 116 of the Act; and ii) residence of a trust under a treaty requires physical nexus to a contracting state.

The case arose from a transaction that was apparently part of a series of estate planning transactions undertaken by a Quebec businessman, Lucien Rémillard. In 1997, a Canadian lawyer formed two Canadian corporations, RCI Environment Inc. and Centre de Transbordement et de Valorisation Nord-Sud Inc., in trust for a trust to be settled under the law of Barbados. That trust, the RCI Trust, was settled in 2002, and it then acquired the shares of the two corporations for $200. Mr. Rémillard was the sole director of each corporation. The beneficiary of the RCI Trust was a Cayman Islands trust, and its beneficiaries were Mr. Rémillard's children and their spouses and issue.

On January 31, 2006, the two corporations amalgamated and continued as RCI Environment Inc. On May 5, 2006, the RCI Trust disposed of the shares of RCI Environment Inc. for $145 million to another corporation of which Mr. Rémillard was the sole director. The trustees of the RCI Trust sought an exemption from the withholding requirements under section 116 on the basis that the trust was a resident of Barbados under the Canada–Barbados Tax Treaty (the "Treaty") and that the disposition of the shares was exempt from Canadian tax under paragraph 4 of Article XIV of the Treaty. The CRA apparently refused to issue a certificate, and the trustees applied to the Federal Court for an order directing the CRA to do so. Because the application sought to compel the CRA to perform a duty, it proceeded in the Federal Court as opposed to the Tax Court of Canada.

The trustees first argued that section 116 did not apply to the disposition on the basis that the disposition was exempt from Canadian tax under the Treaty, and alternatively argued that they had fulfilled all of the requirements under section 116 and were entitled to a certificate. The Minister replied that the issuance of a section 116 certificate confirming a treaty exemption is a matter of discretion and that the trustees had not satisfied the CRA that the Treaty applied to exempt the disposition. The Minister also argued that the trust may have been resident in both Canada and Barbados on the basis that section 94 may deem the trust to have been a resident of Canada because the beneficiaries of the Cayman Islands trust were Canadian residents.

As noted above, Simpson, J. concluded that section 116 does not apply where no tax is owing because of a tax treaty. This conclusion is surprising. Unlike Part XIII of the Act, for example, section 116 does not impose final, definitive tax; section 116 merely requires that a purchaser of taxable Canadian property withhold an amount on account of a non-resident vendor's potential tax liability. The purpose of this withholding is to ensure that Canada can collect tax from non-residents who sell taxable Canadian property. Because section 116 imposes non-final withholding tax, both the CRA and the tax community had long believed that Canada's tax treaties did not trump section 116.

Simpson, J. noted that section 116 predates the negotiation and signing of the Treaty, and suggested that if the drafters intended that section 116 apply notwithstanding the Treaty, she would have expected the Treaty to expressly address its interaction with section 116. She also referred to the amendments to section 116 introduced in the 2008 Canadian federal Budget. These amendments created two exceptions from the requirements of section 116 where no tax is owing because of a tax treaty. As these new exceptions apply only for dispositions that occur after 2008, they were not applicable to the sale of the shares of RCI Environment Inc. Simpson, J. held that these amendments supported her conclusion that the Treaty is paramount over section 116. Other commentators have expressed surprise at this comment on the basis that Simpson, J.'s conclusion means that the amendments were unnecessary (see Nathan Boidman and Michael Kandev, "Can a Treaty Override Domestic Backup Withholding Rules? The Canadian Decision in *RCI*" *Tax Notes Int'l*, June 8, 2009, p. 867).

Regarding the residence of the RCI Trust for the purposes of the Treaty, Simpson, J. noted that paragraph 1 of Article IV of the Treaty refers to a person liable to taxation in the state by reason of "domicile, residence, place of management or any other criterion of a similar nature". Simpson, J. held that criteria of a similar nature "would include other aspects of actual physical presence and not more esoteric concepts such as deemed residence" (at para. 37). She also noted that, like section 116, section 94 existed when the Treaty was negotiated, and the drafters could have dealt with it had they intended it to apply notwithstanding the Treaty. Finally, she held that paragraph 3 of Article IV of the Treaty – which permits the competent authorities to settle the question of dual residency under the Treaty – applies only where the dual residence results from the factors in paragraph 1 of Article IV. Accordingly, she concluded that residence under the Treaty must be based on actual physical factors.

The trustees argued that i) the RCI Trust was settled under the laws of Barbados; ii) the trustees were citizens of and residents of Barbados; iii) the trust's business office was in Barbados and it had one employee; iv) the trust filed tax returns in Barbados; and v) the trust's accountants were in Barbados. Based on these facts and the absence of physical factors linking the trust to Canada, Simpson, J. concluded that the trust was resident only in Barbados.

Simpson, J. ordered the Minister to provide the trustees with a written decision indicating whether the shares of RCI Environment Inc. were treaty-exempt property under the Treaty. The Minister appealed this decision to the Federal Court of Appeal (filed May 27, 2009, Court File No. A-21909). At the Minister's request, and with consent of the trustees, Richard, C.J. stayed the order of the Federal Court pending final disposition of the appeal. The stay was granted on condition that the Minister take all reasonable steps to expedite the hearing of the appeal. Given the conclusions reached by the Federal Court in this case, presumably both the CRA and the tax community will eagerly await the decision of the Federal Court of Appeal.

– Jeffrey Love, McCarthy Tétrault LLP

Prescribed Interest Rates – Fourth Quarter of 2009

The prescribed interest rates for the fourth quarter of 2009 are unchanged from the third quarter and 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 October 1, 2009 to December 31, 2009.

Spousal Attribution Re: Joint Line of Credit

The CRA was asked for its view on the tax treatment of an arrangement where a married couple uses a joint line of credit.

A married couple acquired a house for which the taxpayer contributed most of the capital to acquire the home. A joint line of credit ("LOC"), secured by the house, was obtained. Each of the taxpayer and the spouse has equal and unrestricted access to the funds available under the LOC. The spouse draws funds from the LOC and invests the borrowed funds in a portfolio of income-producing investments.

Specifically, the CRA was asked whether:

- there will be attribution to the taxpayer pursuant to subsection 74.1(1),
- the use of the funds drawn from the LOC constitutes an indirect transfer under subsection 56(4.1) or 56(2), and
- the use of the funds from the LOC constitutes a guarantee under subsection 74.5(7).

Generally, the CRA stated that it is a question of fact as to whether the attribution rules or interest deductibility under paragraph 20(1)(*c*) operated in a given set of facts. Further, the application of the anti-avoidance provisions of subsection 74.5(11) or subsection 245 were also fact-specific.

The CRA stated that the provision of collateral for a loan does not constitute a loan or transfer of property and would not, in and of itself, result in the application of the attribution rules in subsection 74.1(1) or 74.2(1).

In the CRA's view, if the taxpayer borrowed funds from the LOC and used the funds to buy a portfolio of investments in the name of the spouse, this would constitute a transfer in respect of subsection 74.1(1) and 74.2(1). Further, such a use of borrowed money would not be an eligible use because the money was not borrowed by the taxpayer for the purpose of earning income.

On the other hand, if the spouse borrowed funds and used such funds to purchase a portfolio of income-producing investments, this would be an eligible use for the purpose of subsection 20(1)(*c*). However, the application of the attribution rules would depend on whether the taxpayer or the spouse paid principal and interest on the LOC. If the taxpayer paid any portion of the principal or interest, subsection 74.1(3) would apply to attribute all future income and loss from the income-producing investments to the taxpayer (pursuant to subsection 74.1(1)). Additionally, regardless of whether the taxpayer pays any amount of the principal or interest, if the taxpayer is obligated, either absolutely or contingently, to ensure repayment of the principal or interest on the joint LOC, then subsection 74.5(7) would operate to deem the taxpayer to have made a loan to the spouse (subject to the commercial loan exception in subsection 74.5(2)), which would engage the attribution rules.

Further, the CRA indicated that subsection 56(4.1) would not apply to the current facts because the subsection requires a loan from the taxpayer to the spouse, although subsection 56(4.3) may operate to engage the attribution rule in subsection 56(4.1) where the taxpayer loaned property to the spouse and the property was used to repay the LOC. Further, if a guarantee is honoured by the taxpayer and the purpose test of subsection 56(4.1) is met, then subsection 56(4.1) could apply. Subsection 56(2) would not apply because the taxpayer has not directed a payment that would otherwise be the taxpayer's.

Finally, the CRA noted that anti-avoidance rules of subsection 74.5(11) and 245 may apply where the primary purpose (or one of the main purposes), of the transactions was to reduce the tax liability of the taxpayer or spouse.

– Document No. 2009-0317041E5, July 20, 2009

Trust Related to a Beneficiary

The CRA was asked to comment on whether a trust may be related to a beneficiary pursuant to subsection 251(1)(*a*) and, if so, what would be the result under section 116.

The CRA stated that under subsection 104(1) a reference to a trust includes a reference to the trustee. Pursuant to subsection 104(2), a trust is deemed to be, in respect of the trust property, an individual. According to paragraph 251(1)(*a*), related persons are individuals connected by blood relationship, marriage or common-law partnership, or adoption.

Accordingly, if the beneficiary is an individual who is connected by blood relationship, marriage or common-law partnership, or adoption to the trustee, the trust and the beneficiary will be related persons for the purpose of the Act, including paragraph 116(6.1)(*b*).

The CRA noted that to be treaty-exempt property for the purpose of subsection 116(6), a related purchaser will have to provide notice under subsection 116(5.02) in respect of the disposition of a treaty-protected property by a non-resident person to a related purchaser.

– Document No. 2009-0311891I7, June 30, 2009

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