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SELECTED TAX ISSUES AND TRAPS ASSOCIATED WITH ESTATE FREEZES

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There are many potential issues and traps that tax practitioners need to navigate to successfully implement and maintain an estate freeze. This is the first article in a series in which I'll discuss a number of these issues. In particular, I will discuss the following topics:

- Part I — benefit issues and freezes;
- Part II — the personal attribution rules in sections 74.1 and 74.2 and subsection 56(4.1);[1]
- Part III — the kiddie tax rules and the trust attribution rules in section 74.3;
- Part IV — the corporate attribution rules in section 74.4; and
- Part V — the association rules and the general anti-avoidance rules ("GAAR"), in the context of estate freezes.

Given the complexity of many of these topics, my objective is to review the main concepts rather than to delve too deeply into the technical issues associated with each of them.

Part I: Benefit Issues and Freezes

The mere act of freezing inherently raises benefit issues since a freeze typically involves capping the value of the freezor's interests in a corporation to permit other family members or a family trust to acquire new growth shares for nominal consideration.

Fortunately, when the freeze is properly implemented, the CRA accepts that taking back properly structured freeze shares[2] will enable new common shares of a frozen corporation to be acquired for nominal consideration after a freeze without the conferral of any benefits.[3] However, if the freeze is not properly implemented, either because of the poor design of freeze shares or because of a failure to properly value the freeze shares, as a result of which the freezor could be considered to have given away some of the existing value in his or her shares, then a host of benefit issues could arise that would result in a freezor being subject to immediate taxation.[4]

Subsection 56(2)

Even where freezes are properly implemented, prior to the *Neuman*[5] decision, there had been a concern that estate freezes that had been set up to permit dividend splitting[6] could result in the freezor being considered to have conferred benefits on beneficiaries of the freeze pursuant to subsection 56(2).[7] Happily, *Neuman* seems to have settled this issue: the Supreme Court confirmed that subsection 56(2) would generally not apply to discretionary dividends and that the application of this provision is not dependent on whether a dividend recipient has made a legitimate contribution to the corporation. However, *Neuman* was decided prior to the enactment of the corporate attribution rules in section 74.4 and the GAAR in section 245, both of which I'll be discussing later in this series of articles. Accordingly, *Neuman* should be applied with a certain amount of caution, particularly where planning is not conventional.

Although the payment of discretionary dividends is now generally viewed as uncontroversial, the *Neuman* decision does not appear to be applicable to dividend waivers, and, as a result, whenever waiving a dividend is being considered, the provisions of subsection 56(2) should be carefully reviewed.

Family Planning Shares

A more recent development is the use of shares that generally have no material rights other than the ability to receive unlimited discretionary dividends. These shares are usually issued for nominal consideration and are generally redeemable and retractable for their nominal subscription amount.

I've most commonly seen these shares issued in situations where professionals operating through professional corporations wish to split income with adult children, but their application appears broader than this. One significant benefit of these shares — a benefit that is not generally available where more traditional types of shares are issued to other family members — is that, should a holder of these types of shares run into issues with creditors, the limited rights associated with these shares would appear to allow them to be repurchased by the corporation for their nominal redemption amount, which will keep that family member's creditors from having a claim against your client's business.

The use of these shares would appear to be acceptable in accordance with *Neuman*, but, as I mentioned previously, care should be taken to minimize the risk that the corporate attribution rules and the GAAR might apply.[8]

In addition, I believe that these types of shares should not be issued by corporations with pre-existing value unless a freeze is implemented first and the freeze shares contain a typical non-impairment clause. Once the freeze is in place, it should be possible to issue these types of dividend sprinkling shares without eroding any existing value of the previously issued shares of the corporation, which should minimize the risk that the issuance of the dividend sprinkling shares could be considered to give rise to the conferral of any benefits on the holders of the shares.

Notes:

[1] Unless otherwise noted, all statutory references are to the *Income Tax Act* (the "Act").

[2] See CRA Document No. 2008-0285241C6, October 10, 2008, for the CRA's views on appropriate share conditions for freeze preferred shares.

[3] For example, under subsections 15(1) and 56(2) and section 246.

[4] For example, under subsections 15(1) and 56(2) and section 246.

[5] *Neuman v. The Queen*, 98 DTC 6297 (SCC).

[6] For example, where share structures permit dividends to be paid on one class of shares to the exclusion of other classes of shares.

[7] For example, see *The Queen v. McClurg*, 91 DTC 5001.

[8] A recent example of the CRA commenting on such shares is found in its response to question 13 at the 2012 Association de planification fiscale et financière du Québec (APFF) conference. See CRA Document No. 2012-0454181C6, dated December 5, 2012 (French translation).