Budget Proposals Targeting Planning Involving Minors is Now Law[1]

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Introduction

The 2011 federal budget contained proposals designed to restrict certain planning strategies designed to avoid the so-called "kiddie tax" rules.[2] These proposals were subsequently incorporated into Bill C-13, as new subsections 120.4(5) and (5) of the Income Tax Act[3], which received Royal Assent on December 15, 2011. [4] This article will provide a high level overview of these rules and their impact on different planning strategies.

Overview of Proposals

When the proposals were first released in the spring of 2011, there were concerns in the tax planning community that the wording of Budget Resolution 23 combined with other recent CRA administrative positions[5] would be the end of many forms of planning involving capital gains splitting with minors.[6] Although the new legislation may impact certain types of capital gains splitting plans involving minors, a number of opportunities appear likely to survive more or less intact, including planning involving the multiplication of the capital gains exemption among family members.

Subsections 120.4(4) and (5) extend the rules in section 120.4 of the Act (the "kiddie tax" rules) to deem income from capital gains realized in respect of a disposition of certain shares by either:

1. a specified individual (essentially as Canadian resident minor) (see subsection 120.4(4)); or
2. a trust, to the extent that amounts of the capital gains can reasonably be considered to be included in the specified individual's (i.e., the minor's) income pursuant to paragraph 104(13)(a) or subsection 105(2)(see subsection 120.4(5)),

to a person who is *not at arm's length* with the specified individual, to be taxed to the specified individual as ineligible taxable dividends subject to the ordinary split income rules ("non-arm's length capital gains"). [7]

These rules are applicable to all non-arm's length capital gains realized on or after March 22nd, 2011, without grandfathering. Consequently, planners will want to try to avoid these rules since top tax rate[8] ineligible dividends are taxed at 32.56% as opposed to a rate of 23.2% for top tax rate capital gains, resulting in non-eligible capital gains being taxed in a comparatively punitive manner.

Winners under the New Rules

It should first be noted that these new provisions do not apply to the sales of shares listed on designated exchanges, shares of mutual fund corporations or "excluded amounts."[9]

It also appears that the new provisions add legitimacy to strategies that may ultimately result in capital gains (exemption) splitting/multiplication with minors, provided the gains are realized in connection with an arm's length share sale.

In the absence of an arm's length sale, amendments made by Bill C-13 to subsection 48.1(1) specifically exclude subsections 120.4(4) and (5) from applying to a deemed disposition under subsection 48.1(1). As a result, it not only remains viable to have specified persons realize deemed capital gains in connection with going public transactions, including capital gains that are eligible for capital gains exemption treatment, it also appears that such planning has the blessing of Finance going forward.[10]

Casualties under the New Rules

As expected, casualties caused by the enactment of Bill C-13 include income splitting transactions with minors that:

1. are intended to cause would be dividend treatment to be "transmogrified" into capital gains;[11]
2. involve transactions that would permit a parent or other non-arm's length person to buy back growth shares from a trust; and
3. involve bona fide family buy-out or other non-arm's length buy-out situations which have no income splitting motivation.

Although the new provisions will eliminate opportunities for capital gains exemption multiplication among minors using any of these strategies, all is not lost. Even for existing planning[12] involving trusts where only minors are beneficiaries, income that in the absence of the extended kiddie tax provisions would have been allocated to minors can instead be taxed in the trust. By doing so, the income can maintain its character as ordinary capital gains[13] taxed in the trust at the same top tax rates[14] that would likely have been applicable to the client in the absence of any planning rather than being taxed at top rate ineligible dividend tax rates in the hands of minors.[15] If appropriate or desirable, capital of the trust could then be distributed to beneficiaries of the trust, including minors, without additional tax.

In addition, to the casualties listed above, non-section 48.1 capital gains exemption crystallization transactions, which can only be effective if income realized upon a crystallization is earned by a specified individual or if such income is allocated from a trust to a specified individual, also appear to be casualties of the new provisions. In this regard, unlike section 48.1 deemed dispositions, which are specifically deemed not to be dispositions for purposes of subsections 120.4(4) and (5) of the Act, there is no similar

exemption for other forms of non-section 48.1 capital gains exemption crystallization transactions.

In this regard, in August 2011 a Finance official informally indicated to the author that Finance was willing to try and come up with amendments to the new provisions that would exempt internal crystallization transactions. However, the final version of the rules did not provide this exemption. In more recent discussions with Finance, it was indicated that while Finance is still sympathetic to the issue and would like to find a way to provide an exemption, a legislated fix to this problem is unlikely to occur anytime soon since the issue has a lower priority now that Bill C-13 has been enacted. [16]

In conclusion, while the new rules contained in subsections 120.4(4) and (5) significantly curtail capital gains splitting strategies involving minors, there still remain several viable planning opportunities.

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[1] The author first wrote on this subject in "The Estate Planner" No. 195, April 2011, "Federal Budget "Targets" Planning Involving Minors". My partner, David Louis, has also written about this subject in Tax Notes No. 580, May 2011, "Freeze Structures – Under Attack" and, more recently, in Tax Notes No. 583, August 2011, "Freeze Structures – Under Attack" .

A prior version of this article called "Update - Federal Budget "Targets" Planning Involving Minors," ("Original Updated Article") was published in CCH Canadian Limited's Tax Notes No. 584, September, 2011 as well as in CCH's Estate Planner No. 201, October, 2011. This version of the article has been updated by the author to reflect the enactment of Bill C-13, and is being reproduced and published in InfoExchange with the consent of CCH and the author.

[2] Budget resolution 23.

[3] R.S.C. 1985, c. 1 (5th Supplement), as amended (the "Act"). Unless otherwise stated, statutory references in this article are to the Act.

[4] Enacted by SC, 2011, c. 24, implementing a number of items from the 2011 Federal Budget, including Budget Resolution 23..

[5] See CRA document 2010-0373621C6. This French only document contains the CRA's views on abusive planning involving family trusts.

[6] David Louis' articles (supra note 1) voiced similar concerns.

[7] The language of the new provisions might lead one to believe that these provisions create their own charging provision separate and apart from subsection 120.4(2). Based on informal discussions with Department of Finance ("Finance"), Finance intends the deemed income under the new provisions to be caught by the split income definition in subsection 120.4(1) and therefore subject to subsection 120.4(2).

[8] For illustration purposes Ontario tax rates have been used.

[9] Generally amounts of income or capital gains from inherited properties under defined circumstances (see subsection 120.4(1)).

[10] Tax planners may want to approach Finance's blessings with a certain amount of caution.

[11] A high/low stock dividend could be paid on common shares held by a family trust (subject to applicable corporate law), i.e., such that the taxable dividend will be restricted to the increase in stated capital, which would also be the ACB of the high/low share. The trust would then sell the share at the redemption price (e.g., to a parent in consideration for a promissory note), triggering the capital gain to the trust, which would be allocated to the beneficiaries in order to utilize low marginal tax rates. The purchaser of the shares would sell the high/low share to a Holdco connected with the corporation that paid the stock dividend, e.g., in consideration for a promissory note from Holdco. The shares would then be redeemed and the proceeds would be used to repay the promissory note to the parent and then to the family trust, which would distribute the proceeds to the beneficiaries. Such planning strategies are the subject of a number of pending GAAR cases.

[12] Please refer to comments in my prior articles on this subject. Traditional estate planning objectives are unaffected by the new provisions.

[13] The CRA may continue to view transmogrification strategies as GAARable transactions, even though there will no longer be income splitting advantages associated with such planning.

[14] A testamentary trust could access low marginal tax rates.

[15] The income would, of course, belong to the trust not the client/freezor.

[16] Practitioners may want to continue to push for this, if for no other reason so that I can keep writing updates to this article!