CCH Tax Notes – May

Freeze Structures – Under Attack

By: David Louis, J.D., C.A., Tax Partner and Michael Goldberg

Minden Gross LLP, a member of MERITAS Law Firms Worldwide.

On a number of occasions, I have stated that a good estate freeze structure should stand the test of time. However, there has been such a flurry of new developments pertaining to estate freezes in recent weeks that some of these structures will be lucky to last a few weeks, let alone years into the future.

The three items I will discuss all relate to situations where there is a share sale of a frozen company. My comments on the first two developments will be fairly brief, as an article on them by Michael Goldberg, my tax partner at Minden Gross, appears in the latest issue of The Estate Planner**[1]** - and was more recently summarized in the National Post**[2]**. But there are a few things I would like to stress.

BR #23 – Capital Gains Splitting with Minors

The first development, Budget Resolution #23 of the March Federal Budget, seems to be a wide-ranging attack on capital gains splitting with minors. Briefly, the proposal results in deemed (non-eligible) dividend status for would-be capital gains from a disposition of shares of a corporation by a minor**[3]**, if part of a series of transactions that includes the acquisition of such shares by a non-arm's length person. The provision applies if the minor would be subject to tax on split income (i.e., the "kiddie tax") in respect of dividends paid on such shares - included are shares of a private corporation. The kiddie tax applies to the deemed dividend, so that it is taxed at top marginal rates.**[4]**

Not only does it appear that a standard estate freeze would be caught by these rules, but one may even get the impression that the wording of BR #23 itself is focused on these structures: This can be seen by remembering that, by virtue of paragraph 251(1)(b) of the Income Tax Act, a beneficiary of a trust is deemed not to deal at non-arm's length with it. Thus, in a standard freeze structure, the growth shares would be acquired by a person – i.e., the family trust - who is not at arm's length with a minor. Furthermore, BR #23 appears to catch freezes implemented prior to the Budget date (March 22nd), provided that the sale takes place on or after the Budget and the sale is part of the same series as the implementation of the freeze itself.

The commentary on this resolution on page 265 of the Budget papers (as opposed to the resolution itself) suggests that the proposal would apply to a more restricted situation: a "disposition of shares to a person who does not deal at arm's length with the minor". An example would include where a trust owned shares in an Opco and it is desired to crystallize the exemption of beneficiaries who are minors by a sale to a parent.**[5]** Looking to the wording of the resolution, this situation would indeed be caught by the proposal, but the resolution itself has a wider scope.

Happily, only sales by minors are specifically caught by BR #23. If a freeze structure was put in place when beneficiaries were minors and capital gains on a subsequent sale are allocated to a person who is 18 or over in the year, the Budget resolution would not apply. But the bad news is that another new development may:

APFF Question 34 – Family Trusts and the Capital Gains Exemption

In Question 34 of the 2010 APFF Round Table, the CRA was asked to comment on situations in which family trusts are misused and could attract the general anti-avoidance rule. Not surprisingly, the CRA identified sequestering capital gains offshore and inter-provincial tax planning as abusive[6]. However, it appears that the CRA also finds the multiplication of the capital gains deduction to be abusive. More specifically, where in the context of a disposition of a taxpayer's shares, a structure comprising a family trust and participation of accommodating parties[7] is put in place with the goal of avoiding tax on capital gains resulting from the disposition of the shares through the utilization of the capital gains deduction, the CRA would view the structure as abusive. The CRA gives no guidance as to whether there are situations in which any degree of capital gains multiplication in respect of a family trust would be acceptable, nor did the CRA confine its remarks to minors claiming the exemption.

For both of the foregoing, the issue is exactly when a freeze structure that turns into a sale will be caught. For BR #23 to apply, the sale must be part of the same series of transactions as the implementation of the freeze. Of course, whether or not this is the case is debatable and largely fact dependent, although the Supreme Court's judgment in Copthorne Holdings will hopefully shed light on this issue when it is released.[8] Trouble is, if the proposal does apply, there is a downside vis-à-vis capital gains status. Apart from the possibility of losing the capital gains exemption, the effect of the resolution is to impose tax on the basis of a non-eligible dividend subject to the kiddie tax, which will attract a higher tax rate than even a non-exempt capital gain.[9] In respect of APFF #34, the CRA seems to say[10] that GAAR may apply if the structure is put in place to avoid tax on capital gains.

Undervalued Freeze Shares and the Reversionary Trust Rules

The latest salvo is a CRA Headquarters letter to the Aggressive Tax Planning Audit Section in Calgary.[11] While the letter is not specific, it may well be the case that it pertains to a freeze into an Alberta trust. It seems that the value of the freeze shares was set at a lower amount than a formal valuation report. Because of this, the CRA indicated that the reversionary trust rules in subsection 75(2) would apply to the arrangement, so that the capital gain would be taxable to the freezor rather than the trust. The CRA's rationale is that there had been a transfer of property to the trust[12] by virtue of the undervaluation; therefore, the reversionary trust rules are engaged, since the individual is a beneficiary of the trust[13] and is also the sole trustee[14].

The CRA's reasoning is largely based on the Garron case[15], involving an offshore freeze structure where the growth shares were held by holding companies which were in turn held by Barbados trusts. The Federal Court of Appeal indicated that the undervaluation of the freeze shares resulted in an acquisition of property by the trusts from the Canadian holders of the freeze shares, so as to trigger the offshore trust rules in paragraph 94(1)(b) of the Act. Also analogous to Garron, the CRA document indicates that the existence of a price adjustment clause in the share purchase agreement would not be of assistance because “at no time were the original proceeds represented by the freeze shares adjusted pursuant to it.”[16]

Because of the effect of the reversionary trust rules, the result of the CRA document would appear to have an effect which is presumably similar to APFF 34: the capital gain from the sale of shares would be taxed in the hands of the freezor, rather than the trust - although one may question the correctness of the CRA's views[17].

What I find interesting is that the CRA seems to be quite willing (eager?) to expand the indirect transfer of property concept in the Garron case beyond the realm of offshore trusts. In this context, I might also mention that the CRA appears to have become enamoured with the sham doctrine, as espoused by the Federal Court of Appeal in the Antle offshore trust case[18] (the actual holding of the case was that the trust in question was not validly constituted[19]). In addition to more well-known recent cases involving this doctrine[20], in J.R. Saint & Associates Insurance Agencies Limited v. MNR[21], the CRA successfully attacked the exclusion of EI and CPP from EPSP contributions in respect of arm's length employees on the basis that the EPSP itself was a sham.[22].

It is becoming more and more apparent that the CRA will be motivated to apply such doctrines to what it considers to be aggressive tax planning, be it international or domestic. This now appears to encompass the use of a family trust for multiplication of the capital gains exemption (at least). Therefore, even structures that manage to survive BR #23 could be in jeopardy of a challenge based on such anti-avoidance doctrines.

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).

---

[1] *The Estate Planner* No. 195, April 2011, CCH Canadian Limited.

[2] “Crackdown is Coming”, Jonathan Chevreau, *Financial Post*, April 27.

[3] BR #23 itself refers to would-be capital gains incurred by a “specified individual”. Per the definition in subsection 120.4(1), this means an individual who:

(a) had not attained the age of 17 years before the year;

(b) at no time in the year was non-resident; and

(c) has a parent who is resident in Canada at any time in the year.

[4] The corporation is not considered to have paid a dividend; e.g., dividend refunds will not be available.

[5] Similarly, the proposals would apply if a trust owns shares in a private corporation, e.g., operated by the parent, and the parent buys the trust’s shares in order to enable minors to use their exemption and to stop future growth from accruing to the trust. In these examples, the transferee would hopefully have increased cost base in respect of the shares. The proposals speak to deemed dividend status in respect of the specified individual (only).

[6] Also identified were subsection 75(2) corporate strips, as well as transactions in which would-be dividend treatment is “transmogrified” into capital gains taxation (also the subject of pending GAAR cases).

[7] This appears to refer to family members acting as accommodators or facilitators to the transaction: this seems to be envisioned in Doc. No. 2010-0374211R3.

[8] In the eyes of the CRA, at least, one possible factor that could be indicative is whether purification structures are put in place at the time of the freeze. In the past, the CRA has stated that it would be difficult for a taxpayer to maintain that he or she had no intention of ever selling the purified shares at the time of the purification reorganization, such that the sale would be part of the same series. See, for example, Doc. Nos. 5-7939, June 30th, 1989, and 9430255, March 9th, 1995.

[9] In Ontario, for example, this would attract a tax rate of 32.57%, as opposed to the 23.2% rate that applies to a non-exempt capital gain taxed at the highest marginal rate.

[10] Depending, of course, on the accuracy of the translation – the document was not released in English.

[11] Doc. No. 2010–0366301I7, November 2nd, 2010.

[12] The issue identified by the CRA, based on subparagraph 75(2)(a)(i), was: did the trust directly or indirectly receive property from the freezor? Thus the concept of a transfer would result in the transferee receiving the property, per subparagraph 75(2)(a)(i). In *Garron*, the acquisition of property appears to be similarly equated to a transfer by the Federal Court of Appeal.

[13] So that subparagraph 75(2)(a)(i) applies.

[14] So that subparagraph 75(2)(a)(ii) and paragraph 75(2)(b) apply.

[15] 2009 DTC 1287 (TCC); sub nom *St. Michael Trust Corp v. The Queen,* 2010 DTC 5189 (FCA).

[16] In the *Garron* case, the Federal Court of Appeal indicated that the price adjustment clause, being based on a determination of fair market value, did not assist the taxpayer because no such determination was made by a tax authority or court – see paragraph 38.

[17] Ironically, the CRA document came out almost immediately after the release of the latest issue of the Canadian Tax Foundation's newsletter, *Tax for the Owner-Manager*. The issue contains two articles that are relevant to the CRA document. An article by Perry Truster questions the validity of *Garron* and, in any event, argues that it should not extend to the reversionary trust rules, based on the subsection 75(2) requirements that the trust must "hold" and "receive" property, although Mr. Truster indicates that "one might reach a different conclusion" (obviously, the CRA has done so). Paragraph 80 of *Garron* indicates: "Parliament chose the words 'directly or indirectly in any manner whatever' in paragraph 94(1)(b) deliberately to capture every possible means by which wealth and income earning potential represented by shares of a Canadian corporation can move to a non-resident trust from a Canadian resident beneficiary of the trust or a person related to that beneficiary". Unlike the wording of the corporate attribution rules (which Mr. Truster also views as problematic in terms of a transfer to a corporation being a benefit to its shareholders) subsection 75(2) contains narrower language, in that "in any manner whatever" is not included in the provision.

The second article, by my tax partner Joan Jung, suggests that, in view of the *Garron* case, as well as *Krauss v. The Queen* (2009 DTC 1394 (TCC); aff'd 2010 DTC 5176 (FCA)), the language in price adjustment clauses should be broadened, for example, to include a proposed assessment or reassessment on the basis that a benefit was conferred as part of the series of transactions involving the issuance of freeze shares, or there has been a disposition or transfer of property or rights to or for the benefit of another shareholder or prospective shareholder (if not inherent in the former concept).

[18] 2009 DTC 1305 (TCC); 2010 DTC 5172 (FCA). In *Antle*, the sham doctrine was *obiter*.

[19] I.e., the trust never came into existence because the "three certainties" of a trust – namely certainty of intention, subject matter and object – did not exist. The Court found that there was no certainty of intention or subject matter.

[20] Notably *Faraggi*, 2009 DTC 5023 (FCA); *Labow*, 2010 DTC 1282 (TCC); *Antle.* I have also heard that the CRA has become fond of asserting this doctrine in tax-case pleadings.

[21] 2010 TCC 168 (CanLII).

[22] The basis was that the EPSP itself contained misrepresentations: the document purported to be a *profit*-sharing trust, whereas salaries of the arm's length employees were largely funneled through the plan (see pars. 18-22). Payments in respect of the owner-manager were, however, successful.