Update - Federal Budget "Targets" Planning Involving Minors

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Draft legislation implementing a number of items from the 2011 Federal Budget, including Budget Resolution 23 (“BR #23”), was released by the Department of Finance (“Finance”) on August 16, 2011. The legislation implementing BR #23 proposes to add new subsections 120.4(4) and (5) to the Income Tax Act (“Act”)(Canada)**2** (collectively, the “Draft Provisions”).

When I wrote about this subject in the spring, I was concerned that the wording of BR #23 combined with other recent CRA administrative positions**3** appeared to be the end of many forms of planning involving capital gains splitting with minors.**4** Although the Draft Provisions may impact on certain types of capital gains splitting plans involving minors, fortunately, a number of opportunities appear likely to survive, more or less in tact, including planning involving the multiplication of the capital gains exemption among family members.

The Draft Provisions propose to extend the rules in section 120.4 (the “kiddie tax” rules) to deem income from capital gains realized in respect of a disposition of shares by either:

1. a specified individual**5** (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 a specified individual’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**6** (“NAL Capital Gains”).

The Draft Provisions do not apply to sales of shares listed on designated exchanges, shares of mutual fund corporations or “excluded amounts”**7** and they are applicable to all NAL Capital Gains realized on or after March 22nd, 2011, without grandfathering. Consequently, planners will want to avoid NAL Capital Gains 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 NAL Capital Gains being taxed in a comparatively punitive manner.

The discussion below assumes that the Draft Provisions will be enacted without further amendments – such an assumption is always a dangerous one to make, as changes are always possible until legislation is formally enacted**9**.

Winners

It appears that the Draft 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, draft amendments to subsection 48.1(1) specifically exclude the Draft Provisions 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?

As expected casualties of the amendments 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 gel 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 Draft 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 Draft 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 Draft Provisions. In this regard, unlike section 48.1 deemed dispositions, which are specifically deemed not to be dispositions for purposes of the Draft Provisions, it appears that a drafting solution could not be found to exempt dispositions that arise in connection with other crystallization transactions from the Draft Provisions. Based on informal discussions with Finance, it is still possible that if a workable drafting solution can be found during the consultation period,**16** internal crystallization transactions may ultimately be exempted from the Draft Provisions in a future draft of the legislation. Keep your fingers crossed.

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1. For the original article, see The Estate Planner No. 195, April 2011, “Federal Budget “Targets” Planning Involving Minors” (“ My Article”). 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” (collectively, “David’s Articles”).

2. Unless otherwise noted all statutory references are to the Act.

3. See document number 2010-0373621C6. This French only document contains views of the CRA provided in question 34 of the 2010 APFF Round Table regarding what the CRA views as abusive uses of family trusts.

4. David’s Articles voiced similar concerns.

5. Generally a Canadian resident minor.

6. The language of the Draft 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 Finance, I understand that Finance intends deemed income under the Draft Provisions to be caught by the split income definition in subsection 120.4(1) and therefore subject to subsection 120.4(2).

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

8. For illustration purposes I have used Ontario tax rates.

9. These days even enactment isn’t always the final word…but what’s a practitioner to do.

10. Based on recent comments from the CRA (see My Article under the heading “APFF Round Table Question 34”) prior to the release of the Draft Legislation, 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. Traditional estate planning objectives are unaffected by the Draft Provisions.

13. The CRA may continue to view transmogrification strategies as GAAR able 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. Submissions can be made until September 16, 2011.