

Revealed: New Tax and Estate Planning Issues

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As time goes by, it is pretty well inevitable that the *Income Tax Act* will become more and more complex; likewise for tax and estate planning structures. Much like what happens when tectonic plates collide, there can be “displacement” as these trends converge, in the form of new – and often downright offbeat – tax and estate planning issues.

This article discusses a few of these issues that I have noticed from my practice.

Spouse/Alter-Ego/Joint Partner Trusts

All three of these types of trusts provide for a rollover when assets are transferred to them. However, the rollover is denied if persons other than the spouse/settlor/partner[1] can receive or otherwise obtain the use of any income or capital of the trust.

A recent Technical[2] raised the question of whether the rollover to a spouse trust would be available if the trustee is *required* to pay life insurance premiums. Not surprisingly, the CRA’s answer was no: a duty to fund a life insurance policy out of trust capital or income would be one under which another person may obtain the use of the trust capital or income.

Actually, this is not a new position. For example, a 2003 Technical[3] queried whether the ability of a trustee to lend funds or provide other forms of financial assistance to a person other than a spouse would taint the trust. The CRA’s answer was that this would be problematic, if the trust permits funds to be loaned (or any other form of assistance to be provided) to anyone other than the spouse for inadequate consideration.

It rapidly becomes apparent that the concept of being able to “obtain the use” is potentially very broad. Even if a loan is on commercial terms, query whether the debtor is nevertheless obtaining the use of the capital. Obviously, these sorts of interpretations make no sense, and I am happy to see that this is not lost on the CRA.

Because the “no use” requirement must presumably be met under the terms of the trust, appropriate language should be inserted. One approach could be to adhere to the requirements of the CRA, including those discussed above. The problem with this is that there could be changes in CRA policy from time to time which could necessitate an amendment to the documents - if possible. Another approach is to require the trustees to adhere to the published policies of the CRA in respect of the “no use” requirement, as delineated from time to time.

Change of Trustees – More Fallout,

The next thing I would like to talk about is the consequences of a fairly recent Technical Interpretation pertaining to a change of trustees.[4] I wrote about this Technical in June of 2005.[5] In a nutshell, it canvasses whether control of a corporation is acquired when the trustee of a trust that controls a corporation is replaced. As I indicated in the article, the short answer is yes (with the possible exception of situations where the replacement trustee is related to the pre-existing trustees).

For many readers, this is old news, as this Technical has now received a great deal of attention[6]. However, what may be less apparent is that, besides a change of trustees itself, the Technical can be problematic in some situations where control of a corporation “passes” to a trust or estate,

particularly with an “outside” trustee. As a reminder, the general rule is that where there is an acquisition of control, the usual loss restriction rules, deemed year-end, and so on, are operative unless the saving provisions in subsection 256(7) apply. However, in such situations, they may not^[7], perhaps because subsection 256(7) was designed for relatively simplistic situations.

While the usual impact of the change of control rules relate to the “streaming” of losses (due to the “similar business” restrictions) and a deemed year-end, I remind you that there could be other implications. For example, paragraph 111(5.1) and (5.2) are intended to crystallize losses due to declines in value in respect of depreciable and eligible capital property (this may actually be a good thing, provided that the “similar business” restrictions are met), and accrued capital losses may drop off (per subsection 111(4)).

November 9th Draft Legislation – Clauses 65 & 66: Safe Income Strips

When tax practitioners finished poring over the November 9th Notice of Ways and Means Motion (now Bill C-33) they found few changes from the previous round of technical amendments^[8] emanating from the December 20th, 2002 proposals other than the notoriously complex proposals relating to non-competes and other restrictive covenants, and changes to proposed section 143.3 (stemming from the *Alcatel* case^[9] relating to SR&ED credits in respect of stock options). Apparently, clauses 65 and 66 are a by-product of the latter. However, soon after the proposals were announced, I received e-mails from anxious colleagues who had discovered to their consternation that the clauses may have a fundamental adverse effect on safe-income strips and other corporate transactions.

My colleague, Michael Atlas, has written about these proposals at length in a recent issue of *Tax Topics*.^[10] For those involved in safe income strips, this article should be studied carefully. For now, let me give you the “Coles Notes” summary:

- Clause 65 provides that the cost base of the shares received as a stock dividend will be reduced to the extent that the amount of the dividend is deductible as an inter-corporate dividend.^[11] So a stock dividend will no longer be a viable method of crystallizing safe-income.
- Clause 66 provides that the cost base of shares will not be increased by any dividend resulting from converting contributed surplus into stated capital, again, if the dividend is a tax-free inter-corporate dividend.

Other methods of safe-income crystallization, e.g., a share redemption with a paragraph 55(5)(f) designation, or an ordinary dividend, are not affected.

For the latter proposal, some additional explanation is in order. These provisions will typically be problematic where a safe-income strip involves an inter-corporate dividend from a Holdco with relatively low retained earnings, rather than a dividend from the retained earnings of Opco itself. With this situation in mind, I note that the methodology that is adversely affected is an increase in stated capital - but only if the increase reduces the corporation’s contributed surplus. However, where a safe income strip in respect of a Holdco is involved, practitioners may often attempt to create contributed surplus (e.g., on a transfer of Opco to Holdco prior to the strip) because of corporate law requirements that a stated capital increase must draw down retained earnings or other surplus accounts.^[12] This maneuver will now be blocked. To add insult to injury, for the purpose of calculating CDA, the acb increases blocked in clauses 65 and 66 will stand^[13], thus reducing the CDA of the vendor corporation. This could be another example of the “feel” that some proposals emanating from Ottawa seem to give off: “punishment” for that Axis of Evil - tax advisors and their well-heeled clients^[14] - who have the misfortune of getting caught in this trap.

In any event, this brings me back to the convergence theme at the beginning of the article – and illustrates a point. Practitioners who work in this complex and sophisticated realm must constantly be aware that the complexities of the *Income Tax Act* can have unintended consequences – in fact, they are almost inevitable. Like colliding tectonic plates, the best we can hope for is that the result will be a mere blip on the Richter scale, rather than a tsunami.

[1] As may be applicable under the respective provisions.

[2] Doc. No. 2006-0185551C6, September 11th, 2006 – Question 2 of the 2006 STEP Round Table.

[3] Doc. No. 2003-0019235, July 17, 2003.

[4] Doc. No. 2004-0087761E5, May 24th, 2005. In the technical, the CRA stated that:

Where a trust has multiple trustees, the determination as to which trustee or group of trustees controls the corporation can only be made after a review of all the pertinent facts, including the terms of the trust instrument. However, in the absence of evidence to the contrary, we would consider there to be a presumption that all of the trustees would constitute a group that controls the corporation.

I also draw your attention to Doc. No. 2005-0111731E5, July 4, 2006, which seems to indicate that each trustee of a trust is considered to own shares held by the trust. If correct, this could have widespread ramifications in respect of association. I make no further comments on this issue in this article.

[5] Change of Trustees = Tax Disaster? *Tax Notes* #510, July, 2005.

[6] And has been brought to the attention of the Department of Finance.

[7] One example could be where “thin-voting” shares are designed to lose voting rights, e.g., on death, and by virtue of this loss, control “passes” to an estate administered by third party trustees by virtue of its pre-existing shareholdings. For example, the “estate exemption” in subparagraph 256(7)(a)(i) indicates that control of a particular corporation shall be deemed not to have been acquired solely because of an estate that acquired the shares because of the death of a person. Even if the thin voting shares are acquired by the estate, is control acquired because of this acquisition? The reason for acquisition of control is the drop-off of the voting rights. (Note that a bequest of the shares, rather than the drop-off of voting rights, would qualify for the estate exemption.) While subparagraph 256(7)(a) (ii) may potentially apply by virtue of a change in the rights or privileges of a share, the person acquiring control by virtue of the change (i.e., the estate) must be related to the corporation immediately before the time the rights change.

[8] July 18th, 2005.

[9] *Alcatel Canada Inc. v. The Queen*, 2005 DTC 387, TCC.

[10] “Beware of pitfalls in November 9th, 2006 Technical Amendments When Crystallizing ‘Safe Income!’” *Tax Topics* No. 1820, January 25th, 2007.

[11] I.e., under subsection 112(1).

[12] E.g., subsection 24(5) of the *Ontario Business Corporations Act*; subsection 26(6) of the *Canada Business Corporations Act*.

[13] Per the proposed revisions to the “capital dividend account” definition in subsection 89(1).

[14] For further comments see “Hidden Agendas - A Month in the Life”, in *Tax Notes*, December 2006, No. #527.