Tax Notes – May

Some More Missives

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As years go by, I see more and more of what looked like "stock" estate planning methodology that does not prove to be the panacea it was thought to be.

A case in point: recent developments pertaining to so-called "single-purpose corporations" relating to US vacation properties and the like. Once upon a time, a single-purpose corporation was looked on as a relatively simple way to avoid US estate tax: I'm old enough to remember the days when these corporations were used rather routinely. But complications ensued. The changes to the Canada-US Tax Treaty in 1995 put pressure on the applicability of the strategy. Eventually, the administrative policy pertaining to single-purpose corporations was discontinued (details are contained in Income Tax Technical News #31R2, May 16, 2006).

However, for structures in place at the end of 1994, grandfathering was allowed until the earlier of the disposition of the US real estate by the single-purpose corporation, or a disposition of the shares of the single-purpose corporation other than a transfer of such shares to the shareholder's spouse or common-law partner as a result of the death of the shareholder. (Special rules were also available for properties under construction or renovation at the end of 2004.) At the time, most people checked whether the clients were eligible for grandfathering, and moved on. In fact, at the 2006 STEP conference, the CRA indicated that it had received "very few questions" concerning the position set out in ITTN #31R2.[1]

However, in recent months the situation has changed dramatically. If you were reading carefully, you saw that grandfathering would apply to "dispositions" of shares, other than those mentioned. In fact, the CRA is using the word disposition in the technical way. In Doc. No. 2011-0426971E5 (February 16th, 2012) the CRA is of the view that grandfathering status is lost under the deemed disposition of single-purpose shares that takes place upon emmigration of the shareholder from Canada (that is, apart from the usual results of the deemed disposition itself[2]). Several months earlier, the CRA expressed the view that the transfer of a corporation's shares as a result of a divorce or the breakdown of marriage would also destroy the grandfathering (Doc. No. 2010-0386871E5, July 7, 2010). Early on, the CRA confirmed that grandfathering relief would continue to apply to the transfer of a single-purpose corporation's shares to a post-71 spousal or common-law partner trust as a consequence of death. However, in Doc. No. 2011-0393401E5 (August 24th, 2011) the CRA was of the view that a transfer to an *alter-ego* trust would be offside. (As would a situation where the corporation redeems all the shares owned by the individual who had contributed the funds to acquire the property, leaving the children of the individual as the shareholders - see 2004-0106241E5, December 20, 2004; and Doc. No. 2006-0185561C6, September 11, 2006.)

When one adds up the recent restrictions (i.e., divorce, emmigration, and possibly sophisticated estate planning) one is left to wonder the usefulness of grandfathered single-purpose company status.

As a reminder, the issue with non-grandfathered corporate-owned vacation properties and the like is whether a shareholder benefit applies – i.e., pursuant to subsection 15(1) of the Act. The applicable policy is expressed in paragraph 11 of IT-432R2. In many cases, the antidote relies on fair market value rent for the use of the property, subject to the caveat that fair market value rent may not "always be appropriate for measuring the benefits, particularly when it does not provide for a reasonable return on the value or cost of the property" – e.g., for luxury homes, particularly where comparable rent doesn't exist. Also, if the single-purpose rules may become problematic, consider converting to a more acceptable structure while the value of US real estate is still depressed.

Eligible Dividends

The next two topics fall into the category of that famous saying "You can't always get what you want". However, unlike the song, I have question marks as to whether the governments' actions are consistent with the "get what you need" part.

Particularly in respect of closely-held private corporations, the existing eligible dividend rules have had (at least) two warts. The first is that you must designate an entire dividend. The larger problem is often that, in the CRA's view at least, to be eligible for the tax break, payment of the dividend requires a contemporaneous notification in writing to the recipients. To this end, various strategies and boiler plate have been unsuccessfully proposed to the CRA to meet this requirement.

The federal budget contains two proposals in this vein. The first is the ability to designate a portion of the dividend as an eligible dividend. Apart from the fact that this applies only for dividends paid after March 28th 2012, I don't have any particular problem with this proposal. However, rather than remove the contemporaneous notification requirement, the government proposes to permit the CRA (again, in respect to dividends paid after March 28) to accept an eligible dividend designation filed up to three years after the day on which the designation was required to be made, if it would be "just and equitable" to permit such a late designation. The budget papers don't specify what would be considered just and equitable in the circumstances, other than considering "affected shareholders"[3].

While some firms treated this announcement as welcome news, in view of the increased scrutiny for private corporations (especially when held by "wealthy" individuals), many accountants may be reluctant to have such an application "on the record", e.g., as it may, in some minds, tip the CRA off as to sloppy compliance. I suppose that the late designation could be applied for if the CRA is already challenging the proper designation of the dividend. But particularly in these circumstances my question becomes even clearer: why does the government require this paperwork, as opposed to dropping the contemporaneous notification requirement - especially since, in most provinces the differentiation between a non-eligible and eligible dividend is a few points.

Joint Ventures

Continuing with the can't-always-get-what-you-want theme, Doc. No. 2012-0432111E5 (March 13th, 2012), contains "somewhat welcome" developments for the new joint venture policy.

As I have indicated in previous articles, the new policy is that, effective for taxation years ending after March 22, 2011, taxpayers must report their joint venture income based on the joint venturer's year-end – that is, deferred joint venture income will no longer be acceptable. However, for additional stub-period income, transitional relief similar to the partnership rules will potentially apply, so that a deferral of the extra income will be offered. But unlike partnerships, which use an estimated formula (that is, estimating current stub-period income based on the previous year's partnership income, subject to adjustments), joint venturers must report actual joint venture income based on their particular year-ends.

The CRA's latest policy is that, if financial data is not available at the time of filing the joint venture participant's return, the CRA will generally accept estimated amounts to be corrected to actual amounts for the purpose of the stub income reporting and amend the transitional relief, as long as the JV participant requests that the CRA amend the relevant return on a "timely basis". The CRA notes that in order for an election for transitional relief to be accepted, the amount of deferred income being brought into income, as well as the amount of the transitional relief being sought, must be specified in the election. (The CRA also recommends that the CCA be computed separately for the transitional period.)

Obviously, this does not alleviate the requirement to compute joint venture income based on the joint venturer's year-end, rather than use the estimated method as is the case with partnerships. However, at least this task can be deferred for a more convenient time, provided that the return is amended on a "timely basis". In summary, you can't always get what you want - but time is on your side.

Other Recent Missives

I would like to mention briefly two other recent Technicals which I found interesting. Although it does not feature particularly revealing new views on the CRA's part, Doc. No. 2012-0435101E5 (March 27th, 2012) illustrates the interaction between subsection 129(6) and the definition of "small business corporation" in subsection 248(1). In the Technical itself, two-thirds of the fair market value of assets of "Propertyco" (with no employees) is rented to a related and associated corporation – "Opco" - and used in Opco's active business (so that the rent paid to Propertyco is deduction therefrom), and one-third of the FMV of the Propertyco assets are rented arm's-length.

Is Propertyco an "SBC" (e.g., for the capital gains exemption)?   The CRA considers subsection 129(6), which deems the rentals to Opco (i.e., on 2/3's of Propertyco assets) to be income from an active business because they were deductible in computing Opco's active-business income. But the CRA points out that subsection 129(6) applies only for the purposes of subsection 129(4) (i.e., investment income status) and section 125 (the small business deduction). It does not apply for the SBC definition in subsection 248(1), so *vis-à-vis* Propertyco's SBC status, subsection 129(6) would appear to be a red herring (even though affected payments are deemed by subsection 129(6) itself to be income from an active business carried on by the Propertyco).

However, an SBC is defined in subsection 248(1) as a CCPC where all or substantially all of the FMV of the corporation's assets are used principally in an active business carried on primarily in Canada by a particular corporation or a corporation "related" to it. Sounds promising. Trouble is, since only two-thirds of the FMV of Propertyco's assets are attributable to such use (i.e., by a related corporation), Propertyco will not be an SBC, presumably under the CRA's usual 90%-of-value benchmark for SBC status to apply.

Doc. No. 2011-0423141E5 (March 21st, 2012) involves a situation where the Settlor is sole beneficiary of a trust, having transferred the sum of $100. The trust subsequently took a loan in the amount of approximately $1M for the acquisition of a rental property. Even though the rented property is to be distributed to the sole beneficiary/Settlor, the CRA is of the opinion that subsection 107(4.1) applies to the distribution of the rental property, so that a rollout is not available, even though it is to the Settlor – who is typically eligible for an exemption from subsection 107(4.1). The implicit problem appears to be that the particular property to be distributed was not received by the Settlor.

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[1] The CRA took the occasion to express the conditions that previously applied to single-purpose corporations:

1. The corporation must be a Canadian corporation within the meaning of subsection 89(1) of the Act.
2. The corporation's only objective is the holding of a residential real property in the U.S. for the personal use or enjoyment of the shareholder.
3. The shares of the corporation are held by an individual or an individual and persons (other than a corporation) related to the individual.
4. The only transactions of the corporation relate to its objective of holding property in the U.S. for the personal use or enjoyment of the shareholder.
5. The shareholder is charged with all the operating expenses of the property by the corporation, with the result that the corporation shows no profit or loss with respect to the property on any of its income tax returns.
6. The corporation acquired the property with funds provided solely by the shareholder and not by virtue of his holdings or that of a related person in any other corporation.
7. The property must be acquired by the corporation on a fully taxable basis, that is, without the use of any of the rollover provisions of the Act.

See Doc. No. 2006-0185561C6, September 11, 2006.

[2] Presumably, the result would be withholding on the subsection 15(1) benefit under subsection 214(3).

[3] However, per the Explanatory Notes to the Ways and Means Motion in respect of the March 23 federal Budget (April 23rd), another factor is to the extent to which the corporation actually had income taxed at the general corporate income tax rate when the dividend was paid. To me, this suggests a policy of largesse. But we will have to wait and see.