CCH Tax Notes - November

Tax and Family Business Succession Planning - What's News?

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After many months of writing, I now have a copy of the third edition of *Tax and Family Business Succession Planning* actually sitting on my desk. Because it is in book form, the publication must be finalized about a month before printing is completed. This article will summarize several new developments that have occurred during this period. The fact that there has been some "news" in this timeframe is not because of some unlucky confluence of events, but rather because the book covers a big chunk of tax and estate planning matters.

Control Premium: Cashing Out

One of the first things that occurred after we "put the book to bed" was that, in late September, the CRA announced an important change in its assessing policy in respect of the control premium issue[1]. It was stated that, in the context of an estate freeze of a CCPC, where a freezor, as part of the freeze, keeps controlling non-participating preference shares in order to protect his or her economic interest in the corporation, the CRA will *generally* ignore control premium for the purposes of the deemed disposition on death pursuant to subsection 70(5). We managed to sneak in an "insert" to the book on this, as well as a brief article in *Tax Topics*[2]. However, after both of these were finalized, I got a call from a senior CRA official who enlightened me on what the CRA had in mind when it threw in the word "generally": the policy should not apply if the freezor continues to retain "thin-voting shares" after he or she has cashed-out of the freeze. As pointed out in the book, an example of this could be where the freeze shares are rolled into a holding company so that the shares can be redeemed without tax,[3] or if the redemption were "covered" by capital dividend and/or RDTOH balances[4]. Presumably, in these circumstances, there would be no "economic interest" left to protect.[5]

While this is clear enough at first blush, when you think about it a bit, there are questions. For example, suppose that instead of redeeming out the freeze shares for cash, a promissory note is received (e.g., for asset protection). Hopefully, the CRA's view would be that the freezor would continue to have an "economic interest" to protect. While the CRA statement is certainly welcome, and may suffice in a straight forward situation, its scope may be somewhat limited[6]: as I have previously pointed out, there is no indication that the administrative policy would apply to an *inter vivos* sale, e.g., where the position is taken that there is no control premium in order to maximize capital gains exemption claims, nor does it specifically pertain to exclusionary dividend share structures, e.g., where the founder of the business retains shares with voting rights as well as dividend rights which may allow the company to be stripped.

Associated Corporations and Trust Beneficiaries

The third edition of the book expands the discussion on the association rules and *inter-vivos* trusts[7]. In a normal discretionary trust arrangement, each discretionary beneficiary is deemed to own all of the shares of the trust in accordance with subparagraph 256(1.2)(f)(ii). But when it comes to being a "beneficiary", how far does this go? Suppose, for example, that my family trust says that in the event my kids and grandkids all get nuked, the shares will go to, say, my third cousin in Vancouver. Is the aforementioned third cousin deemed to own the shares? In Question 11 of the 2008 APFF Round Table,[8] the CRA was asked about a person's status as a beneficiary, if entitled

to receive shares under a default clause based on the provisions of an individual's will or laws of intestacy, which would be applicable if the primary beneficiaries were not alive or in existence. The CRA conveniently ducked the issue, but indicated that in its view, subsection 248(25), which contains the expanded concept of "beneficially interested", does not apply to subparagraph 256(1.2)(f)(ii).

This seemed to be supported in the recent *Propep* case[9], in which the Tax Court of Canada held that a "second ranking" beneficiary under the Civil Code of Quebec whose interest was conditional on the winding-up of a corporation which was a "first ranking" beneficiary, was not a "beneficiary" for the purpose of subparagraph 256(1.2)(f)(ii).

However, the *Propep* case was very recently overturned by the Federal Court of Appeal[10]. Besides indicating that beneficiary status applied to the second ranking beneficiary because he was an income beneficiary and the trustees had the ability to wind-up the corporation in question, the case seems to indicate that, notwithstanding the consensus of most practitioners as well as the CRA, subsection 248(25), with its expansive meaning of "beneficially interested", does apply to the provisions in the association rules pertaining to beneficiaries.[11]

Residence of a Trust

Chapter 8 of the book discusses the choice of executors[12].
By way of introduction to this discussion, I mentioned the *Thibodeau Trust* case[13], involving residence of trusts. My tax partner, Joan Jung, suggested that, in view of the rather sparse Canadian authority on this issue, I should include some comments on the CRA's position - that residence of a trust is based on the central management and control concept[14], rather than the residence of the trustees *per se*. Notwithstanding my protestations that the mention of *Thibodeau* was somewhat peripheral to the discussion, I decided to add this material: I have found that following Joan's suggestions is a wise move.

Of course, just after the book was finalized, the *Garron* case[15] pertaining to the residence of trusts came out, specifically endorsing the central management and control test for trusts' residence (as well as the *Antle* case,[16] dealing mainly with the question of whether a trust was validly created). So if my remarks may seem somewhat prescient, it's not my doing. Because so much has been said about these cases - with a lot more to come as the fall goes on – I will not comment on them at this time, other than to say that I will find it extremely interesting to watch how trustees and tax planners cope with the decisions on both a go-forward basis and for existing files.[17]

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[1] British Columbia Tax Conference, September 22. The control premium issue is discussed at ¶227 of the book.

[2] No. 1960, October 1st, 2009.

[3] This, of course, assumes that subsection 55(2) and Part IV tax do not apply. This is discussed at ¶204b of the book.

[4] See ¶202 of the book for further discussion.

[5] Of course, as I have pointed out in previous articles, thin-voting shares might also protect the ability to receive bonuses and control the destiny of the business; however, I gather that this doesn't count as an "economic interest" in the CRA's eyes.

[6] Besides deemed dispositions occurring pursuant to subsection 70(5) as specified in the statement, hopefully, it would also apply for other deemed dispositions on death (i.e., by a spouse, *alter ego*, or joint partner trust).

[7] See ¶319 of the book.

[8] Doc. No. 2008-0285041C6, October 10, 2008.

[9] 2009 DTC 1163.

[10] 2009 CAF 274.

[11] The case has been reported only in French, so I am going on a computer translation. However, paragraph 24 appears to indicate that the application of subsection 248(25), is not dependent upon the actual use of the term “beneficially interested” in a particular provision.

[12] See ¶801a *et seq.* of the book.

[13] *Nicholas Bayard Dill and James Appleby Pearman, Trustees of the Thibodeau Family Trust, Plaintiffs, v. The Queen,* 78 DTC 6376 (FCTD).

[14] I.e., .a trust is generally considered to reside where the trustee or other legal representative who manages or controls the trust assets resides.

[15] 2009 TCC 450.

[16] 2009 TCC 465.

[17] On a more technical note, in ¶223 of the book, it is mentioned that, in a situation where a trust subscribes for shares of a corporation and the corporation could potentially be a beneficiary of the trust, CRA Doc. No. 2006-0218501E5 indicates that the CRA has reversed its prior position and that it would not apply subsection 75(2) provided that the trust subscribed to shares for an amount equal to such shares’ fair market value. Question 13 of the 2007 APFF Round Table (Doc. No. 2007-0243241C6, released on PROTOS® on October 14) extends this administrative largesse to apply to dividends paid on the shares or amounts received at the time of the acquisition or redemption of the shares.