TAX FOR THE Owner-Manager

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Trust Planning: Avoiding Some Traps

Trust activities should be monitored regularly, especially shortly before the trust's year-end. Problems that might arise can often be averted. This note identifies some of the traps that are easy to overlook.

Case 1

Trap: The trust owes interest on indebtedness incurred to acquire property. The loan was made interest-bearing to protect the income from the property from the attribution rules (section 74.5).

Consequence: If the interest is not paid within 30 days after the trust's year-end, any income from the property will be attributed to the transferor-lender for all future taxation years. At that point, the only option is to repay the loan.

Solution: To avoid the problem, ensure that the interest is paid each year within the 30-day period.

Case 2

Trap: A majority of the controlling trustees are planning to emigrate from Canada.

Consequence: A trust is generally resident where a majority of its controlling trustees reside. If those trustees emigrate, the trust will become a non-resident of Canada. At that point, all the tax consequences associated with the emigration of the trust will apply, including the triggering of the proposed taxpayer migration rules.

Solution: To avoid this result, replace the emigrating trustees with Canadian residents before the current trustees emigrate. Review the terms of the trust deed, and determine whether it is necessary to obtain court approval for the change.

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Case 3

Trap: A trust that incurred losses in preceding years has income in the current year. Under the trust deed, all of the trust's income must be distributed annually.

Consequence: Unless action is taken, the trust will have no income to absorb the losses.

Solution: Consider electing under subsection 104(13.1) to tax the income in the trust, notwithstanding that the income will be paid to the beneficiaries. This election must be made in the trust's tax return for the year.

Case 4

Trap: A family member is about to make a contribution to an existing testamentary trust.

Consequence: A testamentary trust pays tax at graduated marginal rates. An inter vivos trust is taxed at the top rate. A contribution to a testamentary trust (other than a contribution by an individual on or after his or her death and as a consequence thereof) will taint the testamentary trust, which will be taxed as an inter vivos trust. The trust will lose the benefit of the marginal tax brackets, be required to have a calendar year-end, and have to pay income tax instalments.

Solution: Instead of making a contribution, the family member should consider making a non-interest-bearing loan to the trust and forgiving it in his or her will. Generally, a loan to a trust is not a contribution of property. (See *Interpretation Bulletin* IT-374.)

Case 5

Trap: A corporation owned by a parent regularly makes loans to a trust for the parent's children. The trust is controlled by arm's-length trustees.

Consequence: Prior to December 24, 1998, it was arguable that the corporation and the trust were at arm's length as a matter of fact, and that the parent and the trust were not "connected" for the purposes of subsection 15(2). Under amended paragraph 251(1)(b), after December 23, 1998, a trust is deemed not to be at arm's length with a person who does not deal at arm's length with any beneficiary. Loans from the corporation clearly fall within subsection 15(2) because a person "connected" with a shareholder (namely, the trust) will have received a loan from the corporation.

Solution: To avoid the subsection 15(2) inclusion in the trust, the trust should repay loans before the day that is one year after the end of the corporation's taxation year.

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Taxation of Stock Options: Still Not Good Enough

A proposal in the February 28, 2000 federal budget will allow employees of public corporations to defer the recognition of a portion of their section 7 stock option benefits until they actually sell the shares acquired on the exercise of stock options. As stated in the budget documents, the intent of this proposal was to "allow a deferral similar to that for U.S. employees under certain U.S. stock option plans." Furthermore, the proposal was touted as "one of the centrepieces of the government's effort to quell the so-called 'brain drain' to the United States." The fact that the deferral is limited is an indication that the Department of Finance is not yet willing to bring our system in line with that of the United States.

After the federal budget was tabled, the CCRA introduced a change of its own concerning stock option taxation. Although this technical change enhances the government's efforts to bring our treatment of stock options in line with that of the United States, it still falls short.

For assessments and reassessments issued after June 16, 2000, the CCRA will now allow the entire section 7 stock option benefit to be added to the optioned shares' ACB at the time of their disposition; one will be required to revise the weighted average calculation as contemplated under subsection 47(1). Although the method of calculating ACB is somewhat confusing, the end result of the exercise will be a tax deferral for the employee.

Consider the following example of how the CCRA intends to apply the technical change. Mr. A owns one share of his publicly traded employer. The share has an ACB of $10. Mr. A acquires an additional two shares under a stock option agreement for $25 per share when the fair market value is $40 per share. Assume that the $25 option price equals the FMV of the shares at the date the option was granted. Consequently, the paragraph 110(1)(d) deduction is available. The optioned shares are sold immediately after purchase.

The end result under the CCRA's new interpretation is a deferral of $5 of taxable income. Note that the CCRA has stated that the new interpretation will not apply if the employee purchases additional shares between the time the options are exercised and the sale of the optioned shares.

While the CCRA's attempt to offer an additional tax deferral is encouraging, we would have preferred an approach that did away completely with the need to average *any* of the optioned shares when making the ACB calculation. This would have reduced complexity while deferring, until the shares are sold, the $5 taxable capital gain calculated in our example.

Traditional Method (Weighted Average)

Employment benefit	
Income inclusion (ss. 7(1)) [2 shares × ($40 − $25)]	$30
Less stock option deduction (para. 110(1)(d))	($15)
Net employment benefit	$15
ACB of shares	
Opening balance	$10
Cost of 2 shares acquired [2 × $25]	$50
Employment benefit	$30
Total ACB	$90
ACB per share [$90/3]	$30
Capital gain	
Proceeds [2 × $40]	$80
Less ACB [2 × $30]	($60)
Capital gain	$20
Taxable capital gain	$10
Taxable income impact	
Net employment benefit	$15
Taxable capital gain	$10
Increased taxable income	$25

New Method (CCRA Interpretation)

Employment benefit	
Net employment benefit (as above)	$15
ACB of shares	
Opening balance	$10
Cost of 2 shares acquired	$50
Total ACB	$60
ACB per share [$60/3]	$20
Capital gain	
Proceeds	$80
Less ACB [2 × $20]	($40)
Employment benefit	$30
	$70
Capital gain	$10
Taxable capital gain	$ 5
Taxable income impact	
Net employment benefit	$15
Taxable capital gain	$ 5
Increased taxable income	$20

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Taxable Shareholder Benefits: Sailing Close to the Wind Under Section 15

If a corporation confers a benefit on a shareholder (an "indirect benefit") rather than paying dividends, the benefit may be taxed under section 15. Though both dividends

and indirect benefits are taxable, the difference in tax treatment is important. An indirect benefit is not eligible for the dividend tax credit and is therefore taxed at a higher rate. A shareholder is required to include the value of an indirect benefit in income only if the benefit is conferred upon the shareholder qua shareholder. Thus, a benefit arising under a bona fide commercial contract with the corporation is not taxable under section 15. Taxable benefits include transfers of property by a shareholder to the corporation at a price in excess of FMV, sales of property by the corporation to a shareholder at a price less than FMV, excessive expenses reimbursed to the shareholder, services performed for the shareholder without fair payment, and forgiveness of shareholder indebtedness.

Two recent cases shed light on the operation of section 15. In *Robinson* (FCTD 2000), the court considered the taxability of benefits conferred in good faith without the knowledge of the shareholder. This often occurs due to clerical errors in less sophisticated corporations. In this case, the accountant misclassified an amount as a credit to the sole shareholder's account. Though no payment had been made when the error was discovered, the fact that the corporation had the financial means to pay the shareholder might have been sufficient to find that a benefit had been conferred. The court ruled that subsection 15(1) should not be interpreted as requiring a strong component of "intent." The applicable rule is that a benefit is conferred upon a shareholder without the intent or knowledge of the shareholder (or the corporation) if the shareholder ought to have known that an indirect benefit had been conferred. If there is a genuine bookkeeping error with respect to a particular amount and that amount is truly significant relative to the corporation's revenue or expenses, a court may conclude that the error should have been caught by someone in the corporation, by the shareholders, or by the outside auditors. The important point of this case is that a credit to the shareholder's account does not constitute a taxable benefit if two conditions are met: first, the entry must have been made in error and in good faith; second, the taxpayer must have received no actual monetary benefit as a result of the error.

In *Erb* (TCC 2000), the members of a partnership included individuals and a corporation of which the individual partners were also shareholders. Two of the partners received draws from the partnership in excess of their shares of income, resulting in a deficit in their capital accounts. The minister assessed them under subsection 15(2), alleging that they had become indebted to the partnership. The taxpayers contended that the resulting capital account deficits were not in law "indebtednesses" due by them to the other partners so as to bring subsection 15(2) into play. The court agreed: it said that although in other circumstances a partner could, as a matter of law, become indebted to the partnership, the setting up of a deficit in the capital account was not such an event for the purposes of subsection 15(2). This may create interesting planning opportunities, although GAAR should be considered with respect to an attempt to interpose a partnership between an owner and his corporation to extract corporate surplus in the guise of a partnership advance.

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Getting Out of the Box: Rectification Orders

> "But our accountant told us there would be no tax consequences . . ."

The decision in *Juliar* (Ontario CA 2000) comes as welcome relief for taxpayers (and their advisers) trapped by the sometimes unfair deemed dividend provisions of section 84.1. The section prevents the removal of taxable surplus as a tax-free capital gain in transactions involving a non-arm's-length transfer of shares to a corporation. Essentially, where section 84.1 applies, the amount of non-share consideration (for example, debt) received on the share transfer in excess of the ACB of the shares as determined specifically for the purposes of section 84.1 ("the hard cost base") is treated as a deemed dividend rather than a capital gain. The problem with section 84.1 is that the hard cost base can be different from the adjusted cost base of shares determined for other purposes of the Act. This was the situation in *Juliar*. The Ontario Court of Appeal upheld a court order that retroactively converted the problematic debt into shares, thus avoiding the deemed dividend.

Juliar is part of a growing list of cases in which taxpayers have avoided adverse tax consequences by persuading a court that the documentation of the transactions in question did not reflect the true intentions of the parties: see *Sussex Square Apartments* (FCA 2000) and *Dale* (FCA 1997). Not surprisingly, the CCRA is not embracing all rectification orders that seek to undo adverse tax results. As Michael Hiltz explained at the Canadian Tax Foundation's 2000 annual conference, the CCRA sees a difference between an error in implementation (which can be rectified) and an error in planning (which cannot). The former is acceptable because the erroneous documentation does not reflect the true intent of the parties. However, in the latter case, the parties planned (and therefore intended) to complete the transaction as documented. The CCRA's approach places a premium on good planning and excuses sloppy drafting and implementation. The Ontario Court of Appeal preferred a more generous approach and it seems

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that the Federal Court of Appeal does too. However, the availability of an order depends on the applicant's ability to prove that the true intention of the parties is not reflected in the documents. The CCRA appears to take the position that a general intent to complete a transaction in a tax-effective manner is not a sufficient expression of intent. Fortunately, the courts are sending the message that they may be more lenient than the CCRA.

The CCRA has yet to formally respond to the decision in *Juliar*. Given the importance of the issue, it is hoped that the CCRA's response will provide clarity and consistency of approach. As matters now stand, there is a good deal of uncertainty on both counts. Further, the CCRA should dispense with the need for rectification orders in obvious cases. The judicial system is stressed enough without having to deal with unnecessary rectification applications. If there is a legal basis for rectification without court approval (which there is in many cases), the CCRA should accept the result without requiring a court order (Judge Bowman's comments in *Sussex Square Apartments*, TCC 1998, notwithstanding).

Unfortunately, the CCRA is still looking to the courts for assistance in deciding between an acceptable retroactive rectification order and what the FCA referred to in *Dale* as inappropriate fiscal revisionism. The Supreme Court of Canada has not ruled on this issue as yet; stay tuned for further developments.

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Section 84.1: Don't Get Caught by It

Section 84.1 has been described as "both subtle in its application and severe in its consequences" (Kellough and McQuillan, *Taxation of Private Corporations and Their Shareholders*, 3d ed., at 4:34). Any proposed transfer of shares of a private company to a second corporation should be carefully reviewed from a section 84.1 perspective: the consequences of being caught by that section are punitive.

When an individual sells shares of a subject corporation to a purchaser corporation, the sale may give rise to a paid-up capital grind in the purchaser corporation and/or a deemed dividend in the hands of the seller under section 84.1. Although it is often viewed as a dividend-stripping provision, the section is triggered whether or not there is an intention to avoid tax. In too many cases, the section comes into play through the carelessness or inadvertence of the professional adviser. Or, as in the situation in *Juliar*, described above, because the adviser was misinformed about the ACB of the client's shares in the subject corporation. *Hickman* (TCC 2000) is another reminder that the section can apply in unanticipated circumstances.

Margaret Hickman owned 42 of the 100 issued shares of Opco. A trust for her three adult children owned all of the shares of a Holdco, which in turn owned 48 of the Opco shares. Margaret and her husband were two of the three trustees of the trust. Decisions of the trust were made by majority vote. In 1993, Margaret sold her Opco shares to Holdco for a consideration of $425,407 and one Holdco preference share. The consideration exceeded the paid-up capital of Margaret's Opco shares by $425,365. The minister added this amount to her income as a deemed dividend under section 84.1.

In these circumstances, there were three conditions for the application of section 84.1: (1) a disposition by an individual of shares of one corporation to another; (2) a finding that the seller and the purchaser corporation were not acting at arm's length; and (3) a finding that after the transfer the two corporations were connected. It was agreed that conditions 1 and 3 were met; the only issue was whether Margaret and Holdco were dealing at arm's length. The court held that they were not.

The trustees of the trust controlled Holdco. Margaret and her husband constituted a majority of the trustees; therefore, they were a related group that controlled Holdco (paragraph 251(5)(a)). Since Margaret was related to this group, she was deemed not to be at arm's length with Holdco (paragraph 251(1)(a)). This technical analysis was enough to bring the share transfer within section 84.1. *Quaere*: would a court have issued a *Juliar*-type rectification order on the facts of this case, it being a reasonable inference that the parties did not intend the transfer to Holdco to be a taxable transaction? On the basis of current CCRA practice, it seems likely that any such application would have been opposed.

There is a lesson here for the prudent adviser: always consider carefully the possible application of section 84.1 when advising on private company estate freezes, purifications, and related reorganizations.

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