Gifts and non-arm's length transactions

LEVEL 1

The ITA does not define **gift** but it should be considered as a voluntary disposition of property for no consideration of any kind. The only elements required for a gift are the intention and capacity of the donor to make the gift, the complete delivery to the donee and the acceptance of the gift by the donee.

Inadequate consideration

The general provisions applicable to a gift are contained in section 69, which specifies the POD deemed to have been received by the donor. Once determined, the deemed POD are used to compute the gain or loss realized on the property gifted. In addition, section 69 specifies the acquisition cost for the recipient of the gift. It also addresses dispositions between persons not dealing at arm's length, at an amount other than FMV.

More specifically, paragraph 69(1)(a) provides that, where a taxpayer has acquired anything from a person with whom he was not dealing at arm's length for an amount in excess of the FMV thereof, he is deemed to have acquired it at FMV.

The purpose of this provision is to prevent any attempt by a taxpayer to inflate the cost of a property in a non-arm's length transaction. However, the vendor must take into account the actual proceeds received on the disposition, since there is no provision in the ITA for adjustment in this regard. (Read IT-209R.)

Example 10-1 illustrates how paragraph 69(1)(a) applies.

EXAMPLE 10-1

Anita Reed owns land costing $10,000, having an FMV of $15,000. She sells the land to her son for $22,000. The land is held by Anita as capital property.

Tax consequences

1. For her son:

   Even though he had paid $22,000 for the land, under paragraph 69(1)(a), he is deemed to have acquired it for $15,000, being the FMV. If he subsequently sells the property, his gain or loss will be computed based on a cost of $15,000.

2. For Anita:

POD	$ 22,000
ACB	(10,000)
Capital gain	$ 12,000
Taxable capital gain (1/2)	$ 6,000

   Even though under paragraph 69(1)(a), the son's acquisition cost is $15,000, there is no adjustment to the vendor's POD. A maximum amount of $7,000 is therefore subject to double taxation if the son sells the land for more than $15,000.

Paragraph 69(1)(b) states that:

Where a taxpayer has disposed of anything to:

- a person with whom he was not dealing at arm's length for no proceeds or for proceeds less than the FMV thereof at the time of disposition
- any person by way of gift *inter vivos*

or

- a trust that does not give rise to a change in beneficial ownership of the property

he is deemed to have received proceeds equal to that FMV. Therefore, the taxpayer cannot artificially reduce the POD.

Note that subparagraph 69(1)(b)(ii) applies even if the beneficiary of the gift is dealing at arm's length with the donor.

Example 10-2 illustrates how paragraph 69(1)(b) applies.

EXAMPLE 10-2

Adrien Hébert owns land costing $20,000, having an FMV of $30,000. Because Adrien does not wish to profit from a transaction with his daughter, he sells her the property for $20,000. The land is held by Adrien as capital property.

Tax consequences

1. For Adrien:

DPOD [69(1)(b)]	$ 30,000
ACB	(20,000)
Capital gain	$ 10,000
Taxable capital gain (1/2)	$ 5,000

2. For his daughter:

Cost of acquisition = amount paid	$ 20,000

Even though under paragraph 69(1)(b), the deemed POD are $30,000, being the FMV, no adjustment is made under the ITA to the purchaser's cost of acquisition. If Adrien's daughter subsequently sells the land for more than $20,000, a maximum amount of $10,000 may therefore be subject to double taxation.

Paragraph 69(1)(c) stipulates that:

Where a taxpayer has acquired property by way of gift, bequest, or inheritance or through a disposition that does not give rise to a change in beneficial ownership of the property, he is deemed to have acquired the property at its FMV at the time it was acquired.

Thus, in cases where the taxpayer has paid some amount of consideration, but the consideration is less than the FMV of the property received, the acquirer does not become the beneficiary of a partial gift, paragraph 69(1)(c) does not apply, and instead the provisions of paragraph 69(1)(b) apply. The acquisition cost remains the price paid, since no adjustment is provided for in that circumstance.

Example 10-3 illustrates the implications of a gift of capital property.

EXAMPLE 10-3

Bertha Ferreira owns a rental property which constitutes capital property:

	Land	Building
ACB or CC	$ 20,000	$200,000
FMV	$ 35,000	$250,000
UCC — class 3	—	$140,000

In 2008, Bertha decides to gift the land and building to her son, John.

Tax consequences

1. For Bertha:

Land

Deemed POD [69(1)(b)]		$ 35,000
ACB		(20,000)
Capital gain		$ 15,000
Taxable capital gain (1/2)		$ 7,500

Building

Deemed POD [69(1)(b)]		$250,000
CC		(200,000)
Capital gain		$ 50,000
Taxable capital gain (1/2)		$ 25,000
The lesser of:		
• deemed POD	$250,000	
• CC	$200,000	$200,000
Less: UCC		(140,000)
Recapture of CCA		$ 60,000

Amount to be included in Bertha's income for 2008:

Taxable capital gain:	
Land	$ 7,500
Building	25,000
Recapture of CCA	60,000
	$ 92,500

2. For John:

Cost of the property [69(1)(c)]	
Land	$ 35,000
Building	$250,000

The word "property" contained in subsection 69(1) has a broad meaning and can include both tangible and intangible property. The term "property" is defined in subsection 248(1).

Subsection 69(1.2) concerns the disposition of property under an agreement between persons not dealing at arm's length, providing for payments for the use of the property in an amount

less than the amount that would have been reasonable between persons dealing at arm's length. The existence of such an agreement could reduce the FMV of the property and affect the eventual capital gain. Subsection 69(1.2) will apply to the disposition of such property for proceeds less than its FMV. In such a case, the proceeds are deemed to be the greater of the FMV of the property, determined without reference to the agreement, and such proceeds determined without reference to subsection 69(1.2).

Subsection 69(4) provides that when the property of a corporation has been appropriated to a shareholder for no consideration or for a consideration below the FMV, if the sale of the property at its FMV would have increased the corporation's income or reduced its losses for the year, then the corporation shall be deemed to have sold the property at the time of its appropriation and to have received proceeds equal to the FMV for it.

Subsection 15(1) could also apply where a corporation acquires a property from a shareholder for an amount in excess of its FMV or if it disposes of property to a shareholder gratuitously or for POD less than FMV.

These rules should be kept in mind when a taxpayer wishes to transfer one or more properties to a person with whom he is not dealing at arm's length for consideration other than FMV. Attribution rules may also apply on such transfers.

For purposes of computing the CCA, paragraph 13(7)(e) states that where a taxpayer has acquired a depreciable property from a person with whom he did not deal at arm's length and the property was capital property of the transferor, a new capital cost must be determined.

Under subparagraph 13(7)(e)(i), where the transferor is an individual who resides in Canada and the transferee's CC exceeds the transferor's capital cost, the transferee's CC is deemed to be the total of

- the transferor's CC

and

- 1/2 of the excess of
  - the transferor's POD

  less the total of
  - the transferor's CC

  and
  - twice the CGD claimed by the transferor on the capital property

In the event that, due to the abolition of the $75,000 CGD on February 22, 1994, an election had been made under subsection 110.6(19) for a non-qualifying real property held on February 22, 1994, an additional adjustment would be required in computing the CC. This adjustment is **not examinable**.

The adjustments provided for in subparagraph 13(7)(e)(i) prevent a taxpayer from increasing the CC, for purposes of calculating the CCA, where the transferor has claimed the CGD (which was possible until 1992) or where only 1/2 of the capital gain has been taxed.

The provisions in subparagraph 13(7)(e)(ii) are the same as those in subparagraph 13(7)(e)(i), except that they apply where the transferor is a non-resident individual or a corporation. In that case the reduction of twice the CGD claimed by the transferor does not apply, since such persons are unable to claim the CGD.

If the transferor's CC exceeds the transferee's CC, under subparagraph 13(7)(e)(iii), the transferee is deemed to have the same CC as the transferor and the excess is deemed to have been allowed as CCA.

The application of subparagraph 13(7)(e)(i) is illustrated in Example 10-4.

EXAMPLE 10-4

Return to Example 10-3. John is deemed to have acquired the building for $250,000 under paragraph 69(1)(c). However, for purposes of CCA, subparagraph 13(7)(e)(i) applies.

Tax consequences

The CC for John is deemed to be the total of the following [13(7)(e)(i)]:

• CC for Bertha			$ 200,000
• 1/2 of the excess of POD for Bertha		$250,000	
over the total			
◦ CC for Bertha	$200,000		
◦ Two times the CGD claimed by Bertha	—	(200,000)	
		$50,000 × 50%	25,000
CC of the building			$ 225,000

Note that paragraph 13(7)(e) applies only for purposes of computing CCA and any recapture or terminal loss on disposition of the capital property. It does not affect the cost of the capital property for purposes of computing the capital gain. This is illustrated in Example 10-5.

EXAMPLE 10-5

Return to Examples 10-3 and 10-4. This time assume that John claims the maximum CCA on the building in 2008 and sells it in 2009 for $300,000, distributed as follows:

Land	$ 40,000
Building	$260,000

Tax consequences for John

2008

CCA of building — class 3[1]

CC [13(7)(e)]	$225,000
CCA — 5%[2]	(11,250)
UCC as at December 31, 2008	$213,750

[1] The building, which was included in class 3 when it was held by Bertha, remains in this class because the transaction was between persons not dealing at arm's length [REG 1102(14)].

[2] The half-year rule does not apply, since the building was acquired from a person with whom John was not dealing at arm's length and who had held it for more than 364 days before the end of 2008 [REG 1100(2.2)].

2009

Recapture:

The lesser of:		
• POD	$260,000	
• CC [13(7)(e)]	$225,000	$225,000
UCC		(213,750)
Recapture of CCA		$ 11,250

Capital gain:

Land

POD	$ 40,000
Cost [69(1)(c)]	(35,000)
Capital gain	$ 5,000
Taxable capital gain (1/2)	$ 2,500

Building

POD	$260,000
Cost [69(1)(c)]	(250,000)
Capital gain	$ 10,000
Taxable capital gain (1/2)	$ 5,000

Inter vivos transfer of property to a spouse, common-law partner, or trust, and so on

There are a number of exceptions to the provisions contained in subsection 69(1). They are found principally in section 73.

Under subsections 73(1.01) and 73(1.02), the disposition of capital property by an individual is considered a qualifying transfer if it is made to

- a spouse or common-law partner
- a former spouse or common-law partner in settlement of rights arising out of their marriage or common-law partnership
- a spousal trust as defined in paragraph 104(4)(a)
- an alter ego trust

or

- a joint spousal or common-law partner trust

Provided both taxpayers are resident in Canada, the one making the qualifying transfer is deemed under subsection 73(1) to have disposed of the capital property for POD equal to

- for depreciable property:

$$\text{UCC of the class} \times \frac{\text{FMV of the capital property transferred}}{\text{FMV of all the capital property of the class}}$$

- for non-depreciable property:

  ACB of the capital property transferred

The transferee is deemed to have acquired the capital property for an amount equal to the POD of the transferor. Under subsection 73(2), where the capital property transferred is

depreciable property and the deemed POD are less than the transferor's CC, the CC of the capital property for the transferee is deemed to be the transferor's capital cost. The excess is deemed to have been allowed to the transferee as CCA.

The provisions of section 73 automatically apply; there is no prescribed form to complete. However, it is possible to avoid the rollover provided for in subsection 73(1) by making an election in the income tax and benefit return for the year of disposition to not have the provisions apply.

Example 10-6 illustrates how subsections 73(1) and 73(2) apply.

EXAMPLE 10-6

Again using Example 10-3, assume that in 2008 Bertha gives land and building to her spouse rather than to her son and that this building is the only property in the class.

	Land	**Building**
ACB or CC	$ 20,000	$200,000
FMV	$ 35,000	$250,000
UCC	—	$140,000

Tax consequences

1. For Bertha:

Land

DPOD [73(1)(a)(ii)]	$ 20,000
ACB	(20,000)
Capital gain	$ —

Building

DPOD (UCC) [73(1)(a)(ii)]	$140,000
UCC	(140,000)
Recapture of CCA	$ —

There will be no capital gain as the DPOD are less than the ACB, and there is no capital loss permitted on depreciable property.

No amount will be required to be included in Bertha's income in 2008.

2. For her spouse:

Cost of the property

Land [73(1)(b)]	$ 20,000

Building

CC for Bertha	$200,000
CCA deemed allowed [73(2)]	(60,000)
UCC	$140,000

Bertha may wish to elect in her 2008 income tax and benefit return that the provisions of subsection 73(1) do not apply. This may be advantageous to her, for example, if she was carrying forward non-capital losses or capital losses. The general rules contained in paragraphs 69(1)(b) and (c) would then apply, so that Bertha would realize a capital gain and

recapture of CCA and the spouse would acquire the property at an increased value, as computed in Example 10-3 (gift to the son).

Even though there are no immediate tax implications in the case of a transfer to which the provisions of subsection 73(1) apply, the disposition of property must be shown in the transferor's income tax and benefit return.

Inter vivos transfer of farm or fishing property by an individual to his child

One of the exceptions to the general rule of section 69 is the transfer of farm or fishing property by an individual to his child. This is contained in subsections 73(3) and (3.1).

The provisions of subsection 73(3.1) apply where the conditions set out in subsection 73(3) are met. Thus, there may be tax deferral if a taxpayer, during his lifetime, transfers to his child who is resident in Canada immediately before the transfer, property that is

- land in Canada
- depreciable property situated in Canada

or

- an ECP.

Such property must be used by him in a farming or fishing business carried on in Canada. Before the transfer, the farm or fishing property must have been used principally in the business of farming or fishing in which the taxpayer, his spouse or common-law partner, his child, his father, or his mother were actively engaged on a regular and continuous basis.

For purposes of section 73 as provided for in subsection 73(6), the word "child" is defined in subsection 70(10) and includes, for the taxpayer

- his grandchild
- his great grandchild

and

- a person who, at any time before he attained the age of 19 years, was wholly dependent on the taxpayer for support and of whom the taxpayer had, at that time, in law or in fact, the custody and control

The transfer may be in the form of a sale or gift. However, certain limits must be respected. If the actual POD are not within the limits listed below, deemed POD will be established. The actual POD must be:

- between the FMV of the property and the UCC for depreciable property [paragraph 73(3.1)(a)]. The UCC of the property transferred is determined as follows:

$$\text{UCC of the class} \times \frac{\text{FMV of the property transferred}}{\text{FMV of all the property of the class}}$$

- between the FMV of the property and its ACB for land [paragraph 73(3.1)(b)]
- between the FMV of the property and 4/3 of the CEC for ECP [paragraph 73(3.1)(c)]

If the actual POD of the farm property are within these specified limits, that amount is deemed to be the transferor's POD and the child's acquisition cost. If the actual POD exceed the specified limits, the transferor's POD and the child's acquisition cost are deemed to be equal to the higher limit. If the actual POD are less than the specified limits, the transferor's POD and the child's acquisition cost are deemed to be equal to the lower limit.

Paragraph 73(3.1)(d) states that section 69 does not apply in determining the POD of such a transfer.

In addition, if the DPOD of depreciable property transferred are less than the transferor's original CC of the property, the CC of the property for the child is deemed to be the original CC and the excess is deemed to have been allowed to the child as CCA. For ECP, where the child continues to carry on the business, he is deemed to have acquired an ECP and to have made an expenditure equal to the deemed POD.

Example 10-7 illustrates how subsections 73(3) and (3.1) apply in five different situations.

EXAMPLE 10-7

1. A farmer transfers farmland having an ACB of $18,000 and an FMV of $24,500 to his child.

	Case 1	**Case 2**	**Case 3**	**Case 4**	**Case 5**
If the actual POD are	$ 17,000	$ 18,000	$ 23,500	$ 26,000	—
The DPOD are	$ 18,000	$ 18,000	$ 23,500	$ 24,500	$ 18,000

2. Assume that the land has an ACB of $18,000 and an FMV of $16,500.

	Case 1	**Case 2**	**Case 3**	**Case 4**	**Case 5**
If the actual POD are	$ 16,000	$ 16,500	$ 18,000	$ 19,500	—
The DPOD are	$ 16,500	$ 16,500	$ 18,000	$ 18,000	$ 16,500

If an individual wishes to transfer a farm or fishing property to his child within the limits specified in subsection 73(3.1), he must undertake the transaction at a chosen price. The transaction must not be carried out at FMV and then all or a portion of the debt forgiven, because the tax consequences would be onerous. The parent would have POD equal to the FMV of the property and the provisions of section 80 would apply to the child regarding the debt forgiven, as shown in Example 10-8.

EXAMPLE 10-8

A farmer wishes to transfer farmland to his child for $150,000.

FMV	$200,000
ACB	$150,000

If the farmland is sold for $150,000, as allowed by subsection 73(3), the POD for the father and the acquisition cost for the son will be $150,000.

However, if the farmland is sold for $200,000 and the farmer then forgives $50,000 of the debt, the POD remain $200,000 and section 80 could apply to reduce the acquisition cost to $150,000 if the son has no loss carryforwards.

Thus, any capital gain on the subsequent disposition of the land by the son could be subject to double taxation, up to a maximum of $50,000.

Under subsections 73(4) and (4.1), a choice similar to that under subsections 73(3) and (3.1) may be made on the transfer of shares of the capital stock of a family farm or fishing corporation or an interest in a family farm or fishing partnership to a child of the transferor who is resident in Canada immediately before the transfer. Shares of the capital stock of a family farm or fishing corporation and interest in a family farm or fishing partnership are defined in subsection 70(10). In this case, the actual POD must also fall within certain limits,

being the FMV and ACB of the property. If the actual POD exceed the FMV and the ACB of the property transferred, the deemed POD will be equal to the higher of the FMV and the ACB of the property transferred. If the actual POD are less than both these amounts, the deemed POD will be equal to the lesser of the ACB and the FMV of the property transferred. The child will be deemed to have acquired the shares or the partnership interest at a cost equal to the transferor's deemed POD. Under paragraph 73(4.1)(d), section 69 does not apply in determining the POD of property transferred.

Read IT-268R4 with regard to the *inter vivos* transfer of farm property to a child.

An individual, other than a trust, who was resident in Canada throughout the particular taxation year and who disposed of qualified farm or fishing property is entitled to claim a CGD of $375,000 on the taxable capital gain. When transferring farm or fishing property, an individual may, therefore, plan the transaction to take advantage of both the choices under subsection 73(3) and (3.1) or 73(4) and (4.1) and the CGD, in the most advantageous combination.

READING 10-2

Attribution rules

LEVEL 1

To reduce income, an individual may consider transferring property to his spouse, or common-law partner, or children. You studied the rules applying to the transfer of property between persons not dealing at arm's length. Now, you must determine who will have to report the income (losses) arising from the property transferred. Special rules are provided for this purpose. They are called the "attribution rules" and are largely contained in sections 74.1 through 75.1. Without these rules, an individual taxed at the top marginal rate would be able to shift income by transferring property to his spouse, common-law partner, or children who are taxed at lower marginal rates.

Transfer or loan to a spouse or common-law partner or a minor

Where an individual transfers or loans property, either directly or indirectly, by means of a trust or by any other means whatever, to

- a person (beneficiary) who is his spouse or common-law partner or who has since become so [subsection 74.1(1)]
- a person (beneficiary) under age 18 who does not deal at arm's length with the individual or is the niece or nephew of the individual [subsection 74.1(2)]

the income or loss of the beneficiary for a taxation year from the property or from property substituted therefore, that relates to the period in the year throughout which the transferor is resident in Canada, is deemed to be the income or loss of the transferor for the year and not of the beneficiary. The expression "indirectly" does not, however, include the transfer or loan of property through a corporation.

Subsection 74.1(2) contains an exception to the extent that any income or loss, as the case may be, will cease to be attributed to the transferor in the year in which the transferee has attained the age of 18. On this subject, read IT-510.

Subsections 74.1(1) and 74.1(2) refer to the concept of substituted property, defined in subsection 248(5). Under paragraph 248(5)(a), where a person has disposed of or exchanged a particular property and acquired other property in substitution therefor and subsequently, by one or more further transactions, has effected one or more further substitutions, the property acquired by any such transaction shall be deemed to have been substituted for the particular property. In addition, under paragraph 248(5)(b), any share received as a stock dividend on another share is also deemed to be property substituted for that other share.

The attribution rules apply to income or loss from property but do not generally apply to business income or losses. However, subsection 96(1.8) contains an exception with regard to the attribution of business income where the business income comes from a partnership. The share of income of a partnership allocated to a partner is considered to be income from property if the partner is a specified member, that is, a limited partner or a person who is not actively involved in the partnership's business or a business similar to that carried on by the partnership.

However, planning may still be undertaken for the spouse or common-law partner or a minor who wishes to start a business. Property may be loaned or transferred to finance a business without the attribution rules applying.

The income or loss from an investment or other property acquired with the income attributed to the transferor represents income or loss of the transferee.

Example 10-9 shows how subsection 74.1(1) applies.

EXAMPLE 10-9

In 2008, Carole Fafard gave her common-law partner, Claude Caron, $200,000. Claude used this amount to acquire Canada Savings Bonds having a 4% interest rate. In 2008, Claude received interest of $8,000 on the investment. In 2009, using the interest earned in 2008, Claude acquired an $8,000 term deposit having a 3% interest rate and retained his Canada Savings Bonds, which again yielded $8,000 in interest income in 2009.

Tax consequences

1. For Carole [74.1(1)]:

2008 — Income from property	$ 8,000
2009 — Income from property	$ 8,000

2. For Claude:

2008 — Income from property	$ —
2009 — Income from property ($8,000 × 3%)	$ 240

Thus, whether Claude deposits $200,000 in his bank account, which yields him 4% interest, or whether he acquires savings bonds (substituted property), the attribution rules apply. However, they do not apply to the interest on the term deposits, since they are an investment acquired with income attributed to Carole.

If the loaned or transferred property is used

- to repay, in whole or in part, borrowed money used to acquire other property

or

- to reduce an amount payable for other property

subsection 74.1(3) provides that the attribution rules will apply. The income or loss attributable to the transferor is computed as follows:

$$\text{income or loss derived from the other property or substituted property} \times \frac{\text{FMV of the loaned or transferred property}}{\text{cost of the other property at the time of acquisition}}$$

Example 10-10 illustrates how subsection 74.1(3) applies.

EXAMPLE 10-10

In 2008, Aline Dubé purchased shares in public corporations for $50,000, which she financed through a bank loan. She sold the shares several months later for $75,000 and invested the POD in a term deposit at 3% for six months, maturing on December 31, 2008. Her spouse, Mike Johnson, made a $15,000 payment on her bank loan on December 1, 2008.

Tax consequences
(Attribution rules only)

Interest income to be declared: $75,000 × 3% × 6/12 $1,125

1. For Mike:

$$\text{interest on term deposit} \times \frac{\text{repayment}}{\text{cost of shares}}$$

Interest income attributed

$$\$1{,}125 \times \frac{\$15{,}000}{\$50{,}000} \times \frac{1 \text{ month}}{6 \text{ months}} \qquad \$56.25$$

2. For Aline:

The balance of the interest on the term deposit, namely, $1,068.75 ($1,125 – $56.25), is included in her income.

If subsection 74.1(3) did not exist, an individual could indirectly lend or transfer property without the attribution rules in subsections 74.1(1) and (2) applying. However, there is no provision in the ITA that attributes a portion of the capital gain to the individual who lends money.

Tax on split income

A tax was introduced on certain passive income of individuals under 18 years of age. According to the Minister of Finance, the tax advantages resulting from income splitting generally benefit only high-income individuals with dependants. This anti-avoidance rule is therefore intended to discourage income splitting with minor children. Thus, some income is taxed at the highest marginal rate (29%) rather than at the usual progressive rates.

Under subsection 120.4(2), the split income of a specified individual has been subject to a tax of 29% since 2000.

Split income, as defined in subsection 120.4(1), is the total of

- taxable dividends received in the year and benefits conferred on a shareholder on shares of a corporation that is not listed on a stock exchange or is not a mutual fund corporation; this income may be received either directly by the individual or through a partnership or trust
- income from a partnership or trust (except for a mutual fund trust), if this income may be reasonably considered to derive from the provision of goods or services by a partnership or trust to a business carried on by
  - a person who is related to the individual at any time in the year
  - a corporation of which a person who is related to the individual is a specified shareholder at any time of the year
  - a professional corporation of which a person related to the individual is a shareholder at any time of the year

A **specified shareholder** of a corporation in a taxation year is defined in subsection 248(1) as a taxpayer who owns, directly or indirectly, at any time in the year, not less than 10% of the issued shares of any class of the capital stock of the corporation or of any other corporation that is related to the corporation. For the purpose of this definition, the following descriptions apply:

- a taxpayer is deemed to own each share of a corporation owned by a person with whom the taxpayer does not deal at arm's length
- each beneficiary of a trust is deemed to own that proportion of all such shares owned by the trust at that time that the FMV of his beneficial interest in the trust is of the FMV of all beneficial interests in the trust; however, a beneficiary who is likely to profit from a discretionary trust that owns shares of a corporation is deemed to own each of the shares held by the trust
- each member of a partnership is deemed to own that proportion of all the shares of any class of the capital stock of a corporation that are property of the partnership at that time that the FMV of the member's interest in the partnership is of the FMV of the interests of all members in the partnership
- an individual is deemed to be a specified shareholder of a corporation that is carrying on a personal services business if the individual performs services on behalf of the corporation and if he or any person or partnership with whom he does not deal at arm's length is, by virtue of any arrangement, entitled to not less than 10% of the shares of a class of the corporation or any related corporation

However, some amounts are excluded from the split income to which this tax applies. They are listed in subsection 120.4(1) in the definition of "excluded amount":

- income from a property that the individual inherited from one of his parents
- income from a property that the individual inherited from any other person if, during the year, the individual was enrolled as a full-time student at a post-secondary educational institution or is eligible for the disability tax credit

Only a **specified individual** as defined in subsection 120.4(1) is affected by the tax on split income. This is an individual who

- had not attained the age of 17 years before the year
- was resident in Canada throughout the year
- has a parent who was resident in Canada at any time in the year

If all the conditions are met, the specified individual must pay a tax of 29% on the split income. Under subsection 120.4(3), this tax may be reduced only by any dividend tax credit and foreign tax credit available in respect of amounts included in the split income. No deduction is granted in computing income and taxable income, except for the amount of the income that is split so that it will not also be subject to the regular tax.

Where a child is required to pay tax on split income, subsection 160(1.2) provides that a parent of the child is jointly and severally liable with him for the payment of the tax, if the parent

- carries on a business, is a specified shareholder of a corporation or a shareholder of a professional corporation that purchased goods or services from a business the income of which is included in the child's split income
- is a specified shareholder of a corporation or a shareholder of a professional corporation, dividends of which were directly or indirectly included in computing the child's split income for the year

Under subsection 74.5(13), the attribution rules in subsection 74.1(2) do not apply to the amount included in computing the split income of a specified individual.

Example 10-11 illustrates how section 120.4 applies.

EXAMPLE 10-11

Beausoleil Inc. is a CCPC whose outstanding shares are held as follows:

- the common shares are wholly owned by a trust whose beneficiaries are the minor children of Jerome Tremblay
- the preferred shares are wholly owned by Jerome, who acquired them in a reorganization of capital that took place a few years ago

Each year, dividends are paid on the common shares of Beausoleil Inc. for an amount corresponding to the costs incurred to pay for the children's education at a private collegiate institute. This amounts to approximately $10,000 per year per child. The trust attributes all the income to the children.

Tax consequences

Until 1999, the children included in their income the dividends from Beausoleil Inc. that were paid and attributed to them by the trust.

The federal tax payable for a child in 1999 was $0, as follows:

Taxable dividend	$ 10,000
Gross-up (25%)	2,500
Taxable income	$ 12,500
Basic federal tax (17%)	$ 2,125
Dividend tax credit (13.33%)	(1,666)
Tax credit for basic personal amount ($6,794 × 17%)	(1,155)
Total tax	$ —

In 2008, under subsection 120.4(2), the tax payable for a child is $1,959, as follows:

Taxable income (non-eligible dividend)	$ 12,500
Federal tax (29%)	$ 3,625
Dividend tax credit (13.33%)	(1,666)
Total tax	$ 1,959

Deemed gain or loss

After identifying the person who is required to include in his income the income or loss derived from property in computing income, the consequences arising on the disposition of the property or property substituted therefore, if any, should be determined.

Under paragraphs 74.2(1)(a) and (b), where an individual has loaned or transferred property to a person who is his spouse or who has since become his spouse, any taxable capital gain or allowable capital loss from the disposition of such property or property substituted therefore is deemed to be a taxable capital gain or allowable capital loss of the transferor. For listed personal property, paragraphs 74.2(1)(c) and (d) apply to deem any gain or loss from such property or from property substituted therefore to be a gain or loss realized by the transferor on the listed personal property.

Therefore, property may be transferred to the spouse without immediate tax consequences under subsection 73(1), that is, without any capital gain or recapture of CCA, but the attribution rules will apply on the subsequent disposition of the property by the spouse. These rules do not apply to transfers or loans of property to a person other than the spouse. In such

cases, the capital gain or loss will be included in computing the income of the transferee, who might, for example, be a minor child.

Under subsection 74.2(2), the taxable capital gain or allowable capital loss attributed to the transferor under subsection 74.2(1) is recognized for purposes of computing the CGD under section 110.6. In addition, capital gains of a trust that are attributed to an individual by reason of subsection 75(2) are eligible for the CGD to the same extent and in the same manner as if the gains had been realized directly by the individual.

Example 10-12 illustrates how subsection 74.2(1) applies.

EXAMPLE 10-12

In 1990, Yvonne Dickson transferred without consideration capital property to her spouse, Tom Leung, and made no election on her income tax and benefit return. At that time, the FMV of the property was $50,000 and its ACB was $20,000. In 1998, Tom sold the property for $80,000 and acquired other capital property with the proceeds of the sale.

In 2008, Tom disposed of the substituted property for $120,000 and acquired other capital property with the POD.

Tax consequences

1. For Yvonne:

<u>1990</u>

DPOD	$ 20,000
ACB	(20,000)
Capital gain	$ —

There are no tax consequences given the spousal rollover under subsection 73(1).

<u>1998</u>

POD	$ 80,000
ACB	(20,000)
Capital gain	$ 60,000
Taxable capital gain (3/4)	$ 45,000

Attributable under subsection 74.2(1)

<u>2008</u>

POD	$120,000
ACB	(80,000)
Capital gain	$ 40,000
Taxable capital gain (1/2)	$ 20,000

Attributable under subsection 74.2(1)

For the entire period the capital property is held by Tom, all income from the property is attributed to Yvonne under subsection 74.1(1).

2. For Tom:

<u>1990</u>

Acquisition of capital property at an ACB equal to the DPOD for Yvonne, namely, $20,000 under subsection 73(1).

<u>1998</u>

There are no tax consequences, since all of the capital gain is attributed to Yvonne under subsection 74.2(1).

<u>2008</u>

There are no tax consequences, since all of the capital gain is attributed to Yvonne under subsection 74.2(1).

Trusts

Under subsection 74.3(1), the attribution rules also apply where an individual transfers or loans property, either directly or indirectly, by means of a trust or by any other means whatever, to a trust in which a designated person is beneficially interested at any time.

As noted in subsection 74.3(2), **designated person** is defined in subsection 74.5(5) as

- the spouse of the individual
- a person under 18 years of age who does not deal with the individual at arm's length or is the niece or nephew of the individual

Beneficially interested, defined in subsection 248(25), refers to a right, whether immediate or future, whether absolute or contingent or whether conditional on or subject to the exercise of a discretionary power by any person or persons, to receive any of the income or capital of the trust either directly from the trust or indirectly through one or more other trusts or partnerships.

Here are some examples of cases where an individual is beneficially interested in a trust:

- the income of the trust is payable to the individual
- the income is retained in the trust and will be paid to the individual when he reaches a certain age
- the individual is a member of a class of beneficiaries each of whom has a residual right under the trust

Income of the trust that is paid or payable to a beneficiary may be deducted from the income of the trust under paragraph 104(6)(b) and included in the income of the beneficiary under subsection 104(13) and paragraph 12(1)(m). Trustees may also choose to have all the income taxed in the trust, in which case the beneficiary has no amount to include in his income, under subsections 104(13.1) and 104(13.2).

Only when the beneficiary is taxed on the income of the trust may the attribution rules apply. The provisions of paragraph 74.3(1)(a) specify the amount that is deemed to be the income of the designated person from the lent or transferred property in computing the transferor's or lender's income for purposes of subsection 74.1(1) in the case of a spouse, or under subsection 74.1(2) in the case of a related minor.

The income attributed to the transferor or lender is the lesser of:

- the income of the spouse or related minor from the trust by virtue of paragraph 12(1)(m)
- $$\text{income earned by the trust from the property loaned or transferred} \times \frac{\text{income of the spouse or minor by virtue of 12(1)(m)}}{\text{total income earned by all designated persons from the trust}}$$

In addition, paragraph 74.3(1)(b) provides for a capital gain or loss to be attributed to the individual under subsection 74.2(1) on the disposition of property transferred to the trust. The attributed amount is equal to the lesser of

- the amount allocated to the spouse under subsection 104(21) in the trust's income tax return for the year
- the net capital gains of the trust for the year from the disposition of property transferred or loaned to the trust or from substituted property

Example 10-13 demonstrates the application of the attribution rules under subsections 74.3(1).

EXAMPLE 10-13

Frank Cameron transfers bonds earning interest of $15,000 per year, for no consideration, to a trust in which his spouse and two children, aged 16 and 20, are beneficiaries. The income earned by the trust for the year is $27,000, including a taxable capital gain of $3,000, $1,800 of which was realized on the disposition of the bonds transferred by Frank. All the beneficiaries have an equal right to the income and capital gains of the trust, which are payable in their entirety during the year. The trust deducted all the income payable to beneficiaries and allocates a taxable capital gain of $1,000 to each beneficiary.

Tax consequences

Under subsection 74.5(5), the spouse and the 16-year-old child are designated persons.

For Frank:

1. Income derived from property

   The lesser of [74.3(1)(a)]:

   - income from the trust earned by the designated person:

     $$\frac{(\$27,000 - \$3,000)}{3}$$ $\underline{\$\ 8,000}$

   - $A \times \frac{B}{C}$

     where

     A = income earned by the trust from the property transferred: $15,000

     B = income from the trust that the designated person must include in his income: $ 8,000

     C = income from the trust that all designated persons must include in their income: $16,000

thus, $\$15,000 \times \frac{\$8,000}{\$16,000}$ $\underline{\underline{\$ 7,500}}$

As a result, $7,500 will be included in Frank's income under subsection 74.1(1) with respect to his spouse, and $7,500 will also be included under subsection 74.1(2) with respect to the minor child.

2. Capital gain

Under paragraph 74.3(1)(b), a computation is required to attribute a portion of the taxable capital gain to Frank to be included in computing his income under subsection 74.2(1). The attributed amount is equal to the lesser of

- the amount allocated to the spouse by the trust: $1,000
- the net taxable capital gain realized on the disposition of the transferred bonds: $1,800

Thus, a taxable capital gain of $1,000 is attributed to Frank with respect to his spouse. No amount is attributed to Frank from the minor child as capital gains are not attributed back from minor children.

Under subsection 74.5(13), the attribution rules provided for in subsection 74.3(1) *do not apply to amounts included in computing a specified individual's split income.*

Corporations

Certain provisions are contained in section 74.4 where an individual attempts to split income by transferring property or making an interest-free loan to a corporation whose shareholders are designated persons and subsequently paying them dividends. This type of transaction would have the same effect as a direct loan.

Section 74.4 provides for attribution rules in this situation. Under subsection 74.4(2), the attribution rules apply where

- property is loaned or transferred, either directly or indirectly, *by means of a trust* or by any other means
- the transaction is between an individual and a corporation
- one of the main purposes of the transfer or loan may reasonably be considered to be to reduce the income of the individual and to benefit a person who is a designated person
- *the corporation is not an SBC*
- the designated person is also a specified shareholder of the corporation

Under these rules, the individual is deemed to have received as interest in the year in which all the conditions are met an amount equal to interest computed at the prescribed rate on the outstanding amount of the loan or transferred property, less the total of the following amounts:

- the amount of interest received in the year by the individual
- 5/4 of the taxable dividends received in the year, on shares that were received from the corporation as consideration for the transfer or as repayment for the loan, other than dividends deemed received under section 84

and

- 5/4 of the taxable dividends received by the designated person if those dividends can reasonably be considered to be part of the benefit sought to be conferred and if they are included in the designated person's split income

Under paragraph 74.4(2)(a), interest is deemed to have been received on the **outstanding amount** of the property transferred. An outstanding amount is defined in subsection 74.4(3).

Where a transfer of property has occurred, the outstanding amount is the excess of the FMV of the property at the time of the transfer over the total of the following amounts

- FMV of the consideration received by the transferor, other than:
  - an indebtedness
  - a share
  - a right to receive indebtedness or a share

  These three elements constitute the "excluded consideration" as defined in subsection 74.4(1).

- FMV of any consideration, other than excluded consideration, received by the transferor from the corporation or from a person with whom the transferor deals at arm's length, in exchange for excluded consideration previously received by the transferor for the property

Where a loan has been made, the outstanding amount is equal to the excess of the principal amount of the loan of money at the time the loan was made or the FMV of the property loaned, over the FMV of any repayments of the loan that are not excluded consideration.

The amount of interest deemed to have been received does not take account of the percentage of shares that the individual holds in the corporation. The calculation is the same whether the shareholder is a majority or minority shareholder.

You have already covered the definition of designated person as set out in subsection 74.5(5). The definition of a specified shareholder which is contained in subsection 248(1), is used for purposes of section 74.4, ignoring paragraphs (a) and (d) of the definition.

However, shares held by the taxpayer in a related SBC are ignored in determining whether the taxpayer is a specified shareholder as described in paragraph 74.5(8)(b).

Note that the tax consequences do not concern the shareholder who receives the benefit but only the person making the loan or transfer, as illustrated in Examples 10-14 and 10-15.

EXAMPLE 10-14

On April 1, 2008, Irene Polansky made an interest-free loan of $150,000 to a corporation in which her spouse, Luc Doyon, owns all the outstanding common shares. The corporation is not an SBC and the fiscal year end is December 31. Irene owns the preferred shares of this corporation and, on October 1, 2008, she receives a dividend of $4,000 on the preferred shares. Assume that the prescribed interest rate is 4% in 2008.

Tax consequences

For Irene:

If it may reasonably be considered that the purpose of the loan was to reduce her income and benefit Luc, a designated person and a specified shareholder, subsection 74.4(2) applies and Irene is deemed to have received interest in 2008 equal to:

Loan amount × prescribed rate × number of months

$150,000 × 4% × 9/12	$ 4,500
Less: 5/4 dividends received	
5/4 × $0	—
Amount attributed to Irene	$ 4,500

No reduction is available because the dividends were paid on shares that had not been received in repayment of the debt.

EXAMPLE 10-15

On February 1, 2008, using the rollover provisions of section 85, Rick Flores transfers shares of public corporations to Interlude Ltd., all the outstanding common shares held by his spouse, Laura Reynolds. The ACB of the shares is $50,000, and their FMV is $400,000. As consideration, Rick receives $50,000 in cash and preferred shares with an FMV of $350,000, yielding a maximum annual dividend of 6%. Interlude Ltd. does not qualify as an SBC, and its fiscal period ends December 31, 2008. On December 1, 2008, Interlude Ltd. paid Rick a taxable dividend of $8,000. Assume that the prescribed interest rate for 2008 is 4%.

Tax consequences

For Rick:

If it may reasonably be considered that the transfer was made for the purpose of reducing his income and to benefit Laura, a designated person and a specified shareholder, subsection 74.4(2) applies and Rick is deemed to have received interest in 2008 equal to:

Unpaid value of shares of public corporations × prescribed rate × number of months

$350,000 × 4% × 11/12	$ 12,833
Less: 5/4 × taxable dividends paid on preferred shares (5/4 × $8,000)	(10,000)
Amount attributed to Rick	$ 2,833

Subsection 74.4(4) states that one of the main purposes of a transfer or loan by an individual to a corporation shall not be considered to be a benefit to a designated person where

- the only interest that the designated person has in the corporation is a beneficial interest in shares of the corporation held by a trust
- by the terms of the trust, the designated person may not receive or otherwise obtain the use of any of the income or capital of the trust while he is a designated person
- the designated person has not received or otherwise obtained the use of any of the income or capital of the trust, and no deduction has been made by the trust in computing its income in respect of amounts paid or payable to, or included in the income of, that person while he was a designated person

Note that the provisions of section 74.4 may result in double taxation. The individual is required to include deemed interest in computing his income, but when the designated person receives taxable dividends paid by the corporation in question, no deduction will be allowed for the deemed interest already included in the individual's income.

LEVEL 2

Persons not dealing at arm's length other than the spouse or minor child

Subsections 56(4.1) to 56(4.3) contain provisions that apply to any property loaned to persons not dealing at arm's length. These provisions ensure that income earned on such property or substituted property is taxed in the hands of the lender.

Subsection 56(4.1) states that where an individual loans property to an individual with whom he does not deal at arm's length and one of the main reasons for the loan is to reduce or avoid tax on the income from the property or substituted property, the income is deemed to be income of the lender. This rule does not apply where the attribution rules contained in section 74.1 or subsection 75(2) apply. In addition, it does not attribute income from property

or loans transferred which generate capital gains or business income. Subsection 56(4.1) also applies where an individual becomes indebted, directly or indirectly, to an individual with whom he is not dealing at arm's length. Thus, in the case of a purchase of property, the rule applies to any unpaid balance of the purchase price to be settled by means of a promissory note.

Subsection 56(4.1) also applies where an individual receives a loan from, or otherwise becomes indebted to, a trust, assuming that the transaction is tax-motivated. Similarly, an individual cannot attribute income to his spouse or common-law partner for a period throughout which the two persons lived separate and apart by reason of a breakdown of their marriage or common-law partnership.

Subsection 56(4.2) contains an exception to prevent subsection 56(4.1) from applying where the loan or the debt bears a commercial rate of interest. The exception applies where the loan bears interest at a rate equal to or greater than the prescribed rate in effect when the loan was made or at a rate that would have been agreed on between parties that deal with each other at arm's length. This exception applies only where the interest payable on the loan for the particular year and each preceding year was paid not later than 30 days after the end of each of the years.

In addition, subsection 56(4.3) contains rules under which subsection 56(4.1) applies to a loan used to acquire property or reduce an amount payable for such property in the same manner as if the property had been acquired directly using the borrowed funds. Similarly, where, because of subsection 56(4.2), the loan does not fall within the scope of subsection 56(4.1) and it is used to repay a loan previously made to the same person with whom the lender does not deal at arm's length, the rule provided in subsection 56(4.1) continues to apply to the income from the property previously loaned or from substituted property.

Under subsection 56(5), the income from the property will not be taxed in the lender's hands if it is included in computing a specified individual's split income for a taxation year. Exhibit 10-1 compares subsection 56(4.1) and section 74.1 with respect to a trust.

EXHIBIT 10-1

Comparison between subsection 56(4.1) and section 74.1

56(4.1)	74.1
• Does not apply to a gift of property	• Applies to a gift of property
• Applies to a trust if the purpose is to reduce or avoid tax	• Applies to a trust, regardless of the purpose of the transaction
• Any income is attributed to the lender or transferor	• Income is attributed to the lender or transferor only if included in the income of the spouse or minor child
• Attribution of income only	• Attribution of income or loss

LEVEL 1

Exceptions and anti-avoidance rules

You have studied several situations where the attribution rules do not apply, such as:

- business income from property transferred or loaned, where the beneficiary is actively involved in the business
- the capital gain or loss from property transferred or loaned to minor children
- income from property transferred to adult children (or other related adults)

- income earned on income that has already been subject to the attribution rules
- income from property loaned or transferred to an SBC
- income from property transferred to a corporation that is not an SBC where the transferor receives consideration the FMV of which is equal to the FMV of the property transferred and the consideration does not consist of shares or indebtedness

Transfers at FMV

In addition to the main exceptions listed above, section 74.5 contains other exceptions.

Under subsections 74.5(1) and 74.5(2), subsections 74.1(1) and 74.1(2) and section 74.2 do not apply on the transfer or loan of property if

- At the time of the transfer, the FMV of the transferred property does not exceed the FMV of the property received by the transferor as consideration.
- Where the consideration includes indebtedness or in the case of a loan
  - interest is charged at a rate equal to or greater than the lesser of
    - the prescribed rate

    or
    - the market rate

    at the time the indebtedness was incurred;
  - the interest payable for the year was paid not later than 30 days after the end of the particular taxation year; and
  - the interest payable in respect of each taxation year preceding the particular year was paid not later than 30 days after the end of each such taxation year.
- Where the property is transferred to or for the benefit of the spouse, the transferor elects in his income tax and benefit return for the year in which the property is transferred not to have the provisions of subsection 73(1) apply. This election is made by declaring the POD equal to the FMV, since it is the provisions of section 69 that apply. Note that in this case the above *two* criteria must also be met for the exception to apply.

Breakdown of marriage or common-law partnership

In addition, under subsections 74.5(3) and 74.5(4), the attribution rules do not apply to attribute income or loss, or a capital gain or loss to the transferor that relates to the period throughout which the transferor is living separate and apart from his spouse or common-law partner by reason of the breakdown of a marriage or common-law partnership. With respect to the capital gain or loss, section 74.2 does not apply if the individual and his former spouse or common-law partner jointly elect in the individual's income tax and benefit return for the taxation year that includes that period or for a previous taxation year.

Contribution to RRSP of spouse or common-law partner

Under paragraph 74.5(12)(a), subsections 74.1(1) and 74.2(1) do not apply to attribute an amount arising from the payment of a premium under an RRSP under which the transferor's spouse or common-law partner is the annuitant, to the extent that the premium is deductible under subsection 146(5.1).

Salary to the spouse or common-law partner or children under 18 years of age

Under paragraph 74.5(12)(b), the attribution rules do not apply to a transfer of property between spouses or common-law partners or to a person who was under 18 years of age in the year and who did not deal with the transferor at arm's length or who was his nephew or niece, where the transfer is made as or on account of an amount paid

- that is deductible in computing the taxpayer's income

and

- that is required to be included in computing the beneficiary's income

Thus, although salary paid to the spouse or common-law partners or to children under 18 for services rendered is a transfer of property, if the above conditions are met, the attribution rules do not apply.

LEVEL 2

Anti-avoidance rules

Special rules are also contained in subsections 74.5(6) to 74.5(9) to ensure that an individual does not avoid the attribution rules by using indirect means.

Under subsections 74.5(6) and 74.5(8), where an individual uses a third party to subsequently transfer directly or indirectly property to a designated person or to a corporation in which a designated person is a shareholder, the attribution rules apply as if the transfer had been carried out directly.

Similar rules apply under subsections 74.5(7) and 74.5(8) where an individual guarantees the complete or partial repayment of principal and interest on a loan made by a third party directly or indirectly to a designated person or to a corporation in which a designated person is a shareholder.

Subsection 74.5(9) contains similar rules where an individual transfers or loans property, either directly or indirectly, to a trust in which another taxpayer is beneficially interested.

Under subsection 74.5(11), the attribution rules do not apply where the main reasons for the transfer or loan or a series of such transactions are to reduce the income taxes that would be payable on the income and gains realized. This would be the case, for example, where an individual having a low marginal tax rate arranges to have income attributed to him for the purpose of reducing his spouse's or common-law partner's income taxed at a higher marginal tax rate, as portrayed in Example 10-16.

EXAMPLE 10-16

John Cheung and Lucien Rose subscribe to common shares of Yucca Ltd., a new corporation, for $100 each.

Immediately afterward, John gives his shares to Janet Gingras, his spouse. Lucien does the same for his spouse, Mary Taylor.

Tax consequences

Under subsection 73(1), there is a disposition of the shares at the ACB in favour of the spouses. Thus, there is no capital gain or loss.

Under subsection 74.1(1), any dividend paid by Yucca Ltd. to Janet and Mary should be included in the income of John and Lucien.

However, if an objective of the transaction was for Janet and Mary to control Yucca Ltd. but because of their income it was preferable for John and Lucien to be taxed on the dividend income, then subsection 74.5(11) might apply. If such was the case, the attribution rules contained in subsection 74.1(1) would not apply. It would be Janet and Mary who would have to include the dividend in their income.

LEVEL 1

Tax liability

Where, by reason of a transfer or loan of property, an amount has been included in computing the transferor's income under sections 74.1 to 75.1, under paragraph 160(1)(d), the beneficiary and the transferor are jointly and severally liable for any increase in the transferor's tax liability arising from the inclusion of such amount in his income. In addition, paragraph 160(1)(e) states that the beneficiary and the transferor are jointly and severally liable for any liability of the transferor for the year of transfer or any preceding taxation year to the extent that, at the time of the transfer, the FMV of the property transferred exceeds the FMV of the consideration received in exchange. The beneficiary of the transfer is personally liable up to the amount of the difference between the FMV of the property transferred to him and the FMV of the consideration given in exchange.

As mentioned in subsection 160(4), these paragraphs do not apply where there has been a transfer of property between spouses or common-law partners pursuant to a decree, order or judgment of a competent tribunal or pursuant to a written separation agreement and at that time the spouses or common-law partners were living apart as a result of the breakdown of their marriage or common-law partnership.

Planning

Following are some options for income splitting which will reduce an individual's tax liability while avoiding the attribution rules.

1. Family members, whether it be the spouse or common-law partner or minor children, having low marginal tax rates should have their own bank accounts. All money not derived from the spouse or common-law partner, or the parents in the case of minor children, should be deposited in a savings account. Thus, if the funds are used to acquire income-producing property, the attribution rules will not apply.

2. For each child whose parent receives the child tax benefit, the amount of the child tax benefit should be deposited into the child's own bank account.

3. If one of the spouses or common-law partners having a low marginal tax rate owns a personal property having a substantial value, the individual may sell the property to the spouse or common-law partner at FMV and invest the funds to earn income on which the attribution rules will not apply.

4. An individual may make a loan to a corporation in which his spouse or common-law partner and/or children own less than 10% of the shares of any class or to an SBC.

5. If property is transferred to the spouse or common-law partner at FMV, an election not to have the provisions of subsection 73(1) apply could be made. The transfer could still be made without tax consequences if the transferor can claim the CGD for qualified small business corporation shares or qualified farm property.

6. It may be advantageous to make contributions to the RRSP of the spouse or common-law partner provided they are not withdrawn before the third year following the year in which they were made.

7. Property may be gifted to related adults not dealing with the transferor at arm's length.

READING 10-3

Estate freeze

LEVEL 1

An estate freeze is a planning technique under which an individual converts growth property to property whose value will remain stable for the purpose of minimizing income taxes on death. Thus, an individual owning shares of a profitable corporation may sell the shares to his children in return for a note payable. The note will not increase in value and will not result in additional income taxes on death.

The estate freeze is often used to reduce income taxes on death and for income splitting purposes by transferring family businesses and other investments to other family members.

An estate freeze in favour of the spouse or common-law partner is generally not used because, on death, there are no income taxes payable on property bequeathed to a spouse or common-law partner. However, it may be useful for enabling both spouses or common-law partners to make maximum use of the CGD.

There are a number of methods that may be used to freeze an individual's estate in favour of one or more persons and, depending on the method used, the transferor may retain total or partial control over the property.

The most common methods used are

- direct sale
- use of a holding company
- reorganization of a corporation's capital
- rollover of farm property to children

Direct sale

The direct sale is the simplest method. Under this method, all or a portion of an individual's estate may be sold to the beneficiaries of his choice. Thus, the individual disposes of growth assets for fixed-value assets. With the CGD, this method is very advantageous, especially for those who do not have large estates. The main disadvantage, however, is that the vendor loses control over the property sold, which is not always the ideal solution.

An individual who chooses a direct sale may obtain the consideration desired or may obtain consideration which is dependent on the financial circumstances of the purchaser, which is usually one of the individual's children. For example, the consideration may be

- cash
- a noninterest-bearing demand note
- an interest-bearing demand note or a note with a fixed maturity date
- a balance of sale
- no consideration (gift) or consideration less than FMV

The vendor should consider the tax consequences of this transaction, particularly regarding the consideration chosen, because section 69 or the attribution rules, together with certain other provisions of the ITA, may apply as shown in Example 10-17.

EXAMPLE 10-17

Germaine Galarneau is considering retiring. She is the sole shareholder of Vertex Ltd., an SBC whose shares are qualified SBC (QSBC) shares, have an FMV of $250,000, and an ACB of $1. She has never claimed the CGD. Her two adult daughters are interested in acquiring the shares of Vertex Ltd. However, they do not have any funds to buy the shares of Vertex Ltd.

If Germaine's estate is large enough to enable her to live comfortably following retirement, she may decide to gift the shares to her daughters immediately rather than waiting until the shares further increase in value. In this way, the future growth would accrue to the daughters.

Tax consequences

1. For Germaine:

DPOD [69(1)(b)]	$250,000
ACB	(1)
Capital gain	$249,999
Taxable capital gain (1/2)	$125,000
CGD [110.6(2.1)]	(125,000)
Income	$ —

2. For each daughter:

Cost of the shares [69(1)(c)] ($250,000 × 50%)	$125,000

Using a holding company

Under this method, an individual transfers his growth property (real estate, shares, unincorporated businesses) to a corporation in return for preferred shares and notes. In this way, he uses a corporation to freeze the value of his estate in favour of the beneficiaries. The beneficiaries will benefit from the future growth of the business and the investments, and the growth will not be taxed on the individual's death.

An estate freeze using a corporation is generally carried out as follows:

- The beneficiaries subscribe for common shares of the corporation. In this way, they participate in the corporation's future growth. To avoid potential problems with the tax authorities in valuing these shares, the beneficiaries should subscribe for the common shares before the property is transferred to the corporation by the transferor and thus avoid having CRA contest the FMV of the common shares on their issue.

- An individual, wishing to freeze assets, transfers growth property to the corporation under subsection 85(1) on a tax-free basis. As consideration, the individual receives fixed-value preferred shares and may also receive a note. The preferred shares received in exchange generally have the following terms:
  - voting rights, in sufficient number to retain control over the corporation. In most cases, the taxpayer agrees to freeze the value of his estate but does not necessarily wish to lose control over his property
  - the right to fixed, non-cumulative dividends at a reasonable rate
  - the right of retraction at the value for which the shares were issued, being the FMV of the property transferred at that particular time
  - the right to priority in redemption in the event that the corporation is wound up or dissolved

- no restriction on transfer of the shares
- the corporation may not pay dividends on other classes of shares with the result that the net assets of the corporation would become less than the total of the redemption price of the preferred shares under the freeze

Following the estate freeze, the future growth in the assets transferred will accrue to the shares held by the beneficiaries. On the individual's death, the growth accruing after the freeze will not be taxed, because the common shares will have been owned by the beneficiaries and not bequeathed by the deceased.

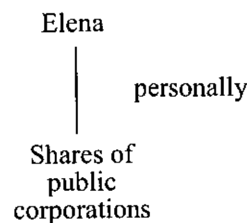
Example 10-18 depicts an estate freeze using a holding company.

EXAMPLE 10-18

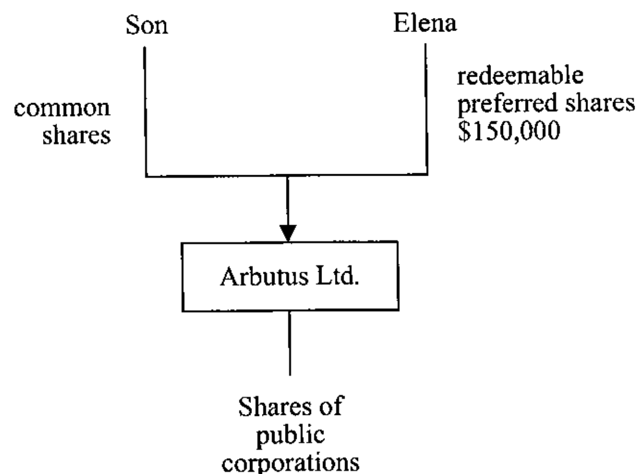
In 2008, Elena Swanson acquired shares of public corporations having an FMV of $150,000 and an ACB of $150,000. Elena believes that in 10 years the shares will be worth $300,000. This is the only property she wishes to bequeath to her adult son. To avoid income taxes on the shares at the time of death, Elena undertakes an estate freeze.

Her son subscribes for a nominal amount of common shares, such as $100 for 100 common shares of Arbutus Ltd., a corporation formed for purposes of the estate freeze. Elena transfers the shares of the public corporations to Arbutus Ltd. and receives preferred shares having a redemption value of $150,000 and a sufficient number of votes to enable her to retain control over Arbutus Ltd., which is now the owner of the shares of the public corporations.

Present situation



Situation after creation of a holding company



However, since Arbutus Ltd. does not qualify as an SBC, and it is reasonable to believe that Elena carried out the above planning in order to reduce her income, the provisions of section 74.4 could have applied if her son was a minor and thus a designated person.

Reorganization of a corporation's capital

An individual owning shares of a corporation with substantial growth potential may wish to freeze the value of such shares. Currently, the method most often used is a reorganization of the capital of the corporation in which the individual holds shares.

Under this method, the transferor converts his common shares in the corporation into voting, non-participating preferred shares, redeemable at the FMV of the shares transferred. The dividend on the preferred shares must be at a reasonable rate and is generally non-cumulative. The terms of the preferred shares were listed earlier in this topic. The beneficiaries of the estate freeze then subscribe for common shares, to which the future growth will accrue.

This conversion may be carried out on a tax-free basis provided the conditions of section 86 are met.

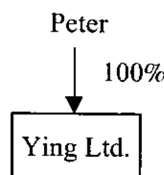
This type of estate freeze is illustrated in Example 10-19.

EXAMPLE 10-19

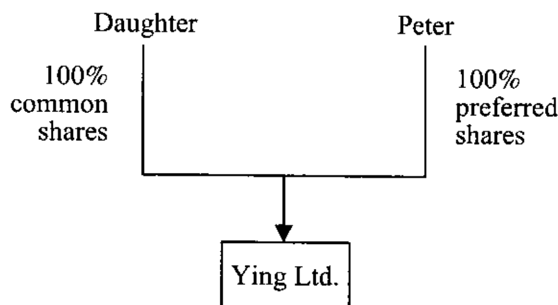
In 1976, Peter Richardson started a manufacturing business, Ying Ltd. At that time, his contribution was in the form of a subscription for common shares in the amount of $10,000. In 2008, the FMV of his shares was $1,000,000. Peter decides to carry out an estate freeze in favour of his only daughter and minimize income taxes payable upon death.

The provisions of section 86 were used to carry out a reorganization of capital and his daughter subscribed for common shares in the amount of $100.

Present situation



Situation after the reorganization



Rollover of farm or fishing property to the children

This method may also be used for estate freezing purposes where the property consists of farm or fishing property, such as land, depreciable property, ECP, shares of a family farm or fishing corporation or an interest in a family farm or fishing partnership. Only these types of property may be rolled over on a tax-free basis on an estate freeze of farm or fishing property.

Use of a trust

A trust is often used in an estate freeze when the owner of the shares of a corporation wants to hold participating shares for the eventual beneficiaries. With a trust, planning can be adjusted according to the individual's situation, such as by delaying the transfer of control to the trust beneficiaries if circumstances so require.

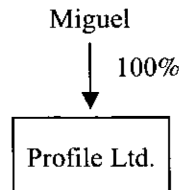
To avoid the attribution rules, a non-income-producing property, such as a gold coin, is given to the trust by an ascendant of the transferor, when the trust is created.

The use of a trust in the case of a simple estate freeze is illustrated in Example 10-20.

EXAMPLE 10-20

Miguel Alvaro owns 100% of the common shares of Profile Ltd. The ACB of the shares is $5,000 and the FMV is $800,000. Miguel has no spouse or common-law partner, and has four children over 18 years of age. He wants to carry out an estate freeze for the benefit of his children while keeping some flexibility over the management of Profile Ltd.

Current situation



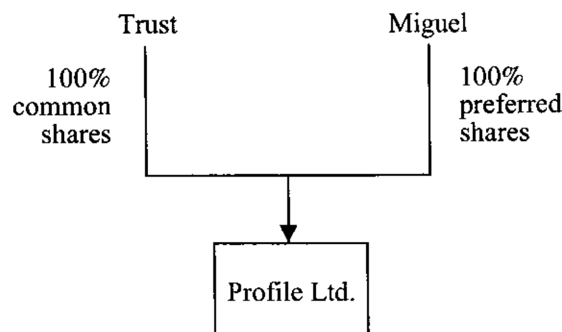
1. Miguel's sister creates a trust and donates a gold coin to it. The beneficiaries of the trust are Miguel's four children, and Miguel is the trustee.

2. The trust borrows $100 from a financial institution or an individual with whom it deals at arm's length. The loan will be repaid when the trust receives dividends from Profile Ltd.

3. The provisions of section 86 are used to carry out a reorganization of capital. Miguel exchanges his common shares for preferred shares with voting rights, redeemable at $800,000. The preferred shares have sufficient voting rights for Miguel to be able to continue to control Profile Ltd.

4. The amount of $100 is used by the trust to subscribe for common shares of Profile Ltd.

Situation after the reorganization and creation of the trust



Estate freeze considerations

In carrying out an estate freeze, using the CGD seems very advantageous since this may be an opportunity to benefit from the crystallization of a capital gain. However, certain anti-avoidance rules introduced, in this respect, to avoid overly aggressive tax planning should be considered. Anti-avoidance rules have also been introduced to prevent surplus stripping, or the conversion of ordinary income to a capital gain eligible for the CGD.

Where the beneficiaries of an estate freeze are minor children of the taxpayer, they may not have the funds required to acquire the shares. The purchase may be financed using child tax benefits, which belong to the minor children. These funds would then be used to acquire the shares to which the future growth of the estate would accrue. However, it should be ensured that the required funds are accumulated in a separate bank account under their name or in trust for them. Otherwise, if the funds are gifted or loaned to the children by the taxpayer or by another related person, the attribution rules may apply.

READING 10-4

Case studies

LEVEL 1

The following two case studies show how essential it is to have a good knowledge of the rules and their purpose in order to solve a client's case or a case presented in an examination.

Case 1

Patricia Jean, a resident of Canada, owns all the common shares (100 shares issued) of Youthglow Ltd. This is a highly profitable Canadian private corporation that manufactures beauty products. Patricia acquired the 100 common shares of Youthglow Ltd. in 1978 from Margot Phan, an unrelated person, for $400,000. Margot had founded the corporation in 1968 and had subscribed for 100 common shares at $10,000, or $100 per share.

Patricia has just turned 55, and she thinks it is time to develop a financial plan for her family and estate. Patricia has had a common-law partner, Pierre, for the past 12 years. Pierre had a work accident in 1999, and his annual taxable income is approximately $20,000. Patricia also has two children: Marc, age 20, and Sophie, age 14. Both are students, and they have no income tax payable annually because of the different deductions and non-refundable credits that are available to them. Under the circumstances, Patricia is considering a plan that will transfer not only capital but also income to her spouse and children.

The 100 common shares of Youthglow Ltd. are currently worth $2,500,000. The only assets of the corporation are, and always have been, those used to carry on the business. Patricia has never claimed the capital gains deduction (CGD).

The transactions considered are as follows:

1. Patricia would create a holding company, Holdco Ltd., to which she would transfer her 100 common shares of Youthglow Ltd., using the provisions of subsection 85(1). The agreed amount would be set at $900,000 to take advantage of the CGD. As consideration for the transfer, Patricia would receive a non-interest-bearing demand note for $900,000 and 1,200,000 preferred shares, redeemable or retractable for $1 each and having a paid-up capital of $1 each. The preferred shares would be voting shares and provide a non-cumulative and non-preferred dividend of 1/2 of 1% per month.

2. The common shares of Holdco Ltd. would be issued for $1 each as follows:

Pierre	100 common shares
Trust for the children	200 common shares

3. Pierre would pay for the 100 common shares with his own funds.

4. The trust for the children would be created by Patricia, who would make a gift of $200. This amount would be used to purchase the 200 common shares of Holdco Ltd. The trustee of the trust would be Pierre. The beneficiaries of the trust would be Marc and Sophie, who each year would be entitled to all the income of the trust in equal shares. The trust would be liquidated when Sophie reached 40 years of age, and the capital would be distributed to them in equal shares.

5. Patricia plans for Youthglow Ltd. to pay annually a dividend of at least $100,000 to Holdco Ltd., because starting in 2009, the profits of Youthglow Ltd. will no longer need to be fully reinvested in the business to ensure that it grows. The funds

transferred to Holdco Ltd. will be used to pay an non-eligible annual dividend of $75,000 to the holders of common shares of Holdco Ltd., with the remainder being kept for reinvestment in Holdco Ltd. No dividend will be paid on the preferred shares.

Required

a. Describe all the tax consequences related to the transfer of the 100 common shares of Youthglow Ltd. to Holdco Ltd. if this transfer is carried out as described in step 1.

b. Describe the tax consequences for the parties involved arising from the payment of the dividend of Youthglow Ltd. to Holdco Ltd. and the dividends of Holdco Ltd. to Pierre and the trust for the children. What elections are available?

c. Does Patricia face other tax consequences from the transfer of the shares of Youthglow Ltd. according to the planned scenario? If so, what are they?

d. What are the tax consequences of deferring the liquidation of the trust until Sophie turns 40?

Solution

a. Consequences of the transfer of the share to Holdco Ltd.

The rollover is carried out under the provisions of subsection 85(1). The agreed amount of $900,000 is acceptable, since it is within the limits specified in paragraphs 85(1)(b), (c), and (c.1), namely:

- The NSC (a $900,000 note) is not greater than the agreed amount of $900,000.
- The FMV of the shares disposed of ($2,500,000) is not less than $900,000.
- The agreed amount of $900,000 is not less than the lesser of the ACB ($400,000) and the FMV of the shares disposed of ($2,500,000).

However, paragraph 85(1)(e.2) applies, since the FMV of the consideration received on the rollover ($2,100,000, made up of a $900,000 note and the preferred shares, which have a value of $1,200,000) is less than the FMV of the transferred shares ($2,500,000), and it is reasonable to consider the difference ($400,000) as a benefit that Patricia wanted to confer on her spouse and children. Therefore, except for purposes of determining the cost of the preferred shares, the agreed amount is adjusted by adding the amount of the benefit to it. The agreed amount is therefore deemed to be $1,300,000 ($900,000 + $400,000).

On the other hand, subsection 84.1(1) applies to the transfer of the shares, since all the conditions set out in this provision are met:

- The shares of Youthglow Ltd. are a capital property for Patricia.
- The vendor, Patricia, is not a corporation.
- Patricia and Youthglow Ltd. are residents of Canada.
- The purchaser, Holdco Ltd., is a corporation.
- Patricia and Holdco Ltd. do not deal at arm's length.
- After the acquisition, Holdco Ltd. holds 100% of both the voting shares and the FMV of the shares of Youthglow Ltd.; the corporations are therefore connected within the meaning of subsection 186(4).

The fact that the transfer is carried out under the provisions of section 85 does not prevent subsection 84.1(1) from applying.

Since Patricia receives both a share consideration and a non-share consideration, paragraphs 84.1(1)(a) and (b) apply.

The tax consequences of the transaction for the parties involved follow.

1. Reduction of the PUC of the preferred shares of Holdco Ltd. [84.1(1)(a)]

A =	$ 1,200,000	
B = The greater of the following:		
(i) $ 10,000		
(ii) $ 400,000	$ 400,000	
Less: FMV of the NSC	(900,000)	
(cannot be negative)	$ —	
C =	$ 1,200,000	
PUC before reduction		$ 1,200,000
Less: Reduction under 84.1(1)(a)		
$(A - B) \times \frac{C}{A}$		
$(\$1{,}200{,}000 - \$0) \times \frac{\$1{,}200{,}000}{\$1{,}200{,}000}$		(1,200,000)
PUC for tax purposes		$ —

2. For Patricia:

Deemed dividend [84.1(1)(b)]

A =	$ 1,200,000	
D =	$ 900,000	
E = The greater of the following:		
(i) $ 10,000		
(ii) $ 400,000	$ 400,000	
F =	$ 1,200,000	
Deemed dividend:		
$(A + D) - (E + F)$		
$(\$1{,}200{,}000 + \$900{,}000) - (\$400{,}000 + \$1{,}200{,}000)$		$ 500,000

Under paragraph 82(1)(b), this deemed dividend must be grossed up by 1/4 when it is included in Patricia's income.

Capital gain on the disposition of the shares of Youthglow Ltd. [39(1)(a)]

POD [54]		
Deemed POD [85(1)(e.2)]	$ 1,300,000	
Less: Deemed dividend [84.1(1)(b)]	(500,000)	$ 800,000
ACB of the transferred shares		(400,000)
Capital gain		$ 400,000
Taxable capital gain (1/2)		$ 200,000
Less: CGD[1]		(200,000)
		$ —

[1] The shares are eligible for the CGD because they meet all the conditions set out in the definition of a "qualified small business corporation share" in subsection 110.6(1):

- Youthglow Ltd. is a CCPC.
- The shares are SBC shares at the time of the disposition, since all the assets of Youthglow Ltd. are used in a business carried on in Canada.
- The shares have been held for more than 24 months.
- During the 24-month period preceding the disposition, more than 50% (in fact, 100%) of the value of the assets is attributable to assets used in a business in Canada.

ACB of the note [85(1)(f)]	$ 900,000

ACB of the preferred shares of Holdco Ltd. [85(1)(g)]

The lesser of:		
• FMV of the preferred shares	$ 1,200,000	
• Unadjusted agreed amount [85(1)(e.2)]	$ 900,000	
Less: FMV of the NSC	(900,000)	
	$ —	$ —

PUC of the preferred shares of Holdco Ltd.

Since Patricia holds all the preferred shares: 100% × $0	$ —

3. For Holdco Ltd.

ACB of the shares of Youthglow Ltd. [85(1)(a) and (e.2)]	$ 1,300,000

b. Payment of dividends

From Youthglow Ltd. to Holdco Ltd.

Youthglow Ltd. and Holdco Ltd. are connected Canadian corporations, since Holdco Ltd. controls Youthglow Ltd. Thus, under section 112, any dividend paid to Holdco Ltd. will be deductible from its income for purposes of Part I tax. Furthermore, Holdco Ltd. will be subject to Part IV tax only if Youthglow Ltd. is entitled to a DTR on payment of the dividend.

Subsection 55(2) does not apply, since this is not a dividend which is intended to reduce the capital gain on disposition of shares and which is attributable to anything other than income earned or realized after 1971.

From Holdco Ltd. to Pierre

Since Pierre paid for the common shares with his own funds, he will be taxed on the dividend that is paid to him. Under paragraph 82(1)(b), the dividend must be grossed up by 1/4 when it is included in Pierre's income.

From Holdco Ltd. to the trust for the children

Since the income is entirely payable to the children under the terms of the trust, the trust can deduct from its income the entire amount of the dividend received; it is then the beneficiaries who will be taxed on the amount of the dividend. However, since Sophie is a minor and the dividend was paid on unlisted shares, the income attributed to her will be subject to the tax on split income for as long as she is a minor, and therefore the dividend will be taxed at the rate of 29%. Since the tax on split income applies under subsection 74.5(13), no amount will be attributed to Patricia under subsections 74.1(2) and 74.3(1).

Under subsection 104(19), the dividend attributed by the trust will be deemed to constitute a taxable Canadian corporation dividend that is subject to gross-up and a tax credit.

Under subsection 104(6), it would be possible to choose not to deduct from the income of the trust, in whole or in part, the amount of the dividend payable to the beneficiaries. Under subsections 104(13.1) and (13.2), the beneficiaries would not have to include in their income the amount taxed in the trust. However, the trust is an *inter vivos* trust taxed at the maximum rate for individuals and does not receive personal tax credits.

If the choice were made to have the income taxed in the trust, the benefit derived from having half the dividend taxed in the hands of Marc — who currently has no tax payable — would be lost. This would also be true for Sophie's share when she becomes an adult.

There would be no advantage in electing to deduct only part of the income payable, since the calculation provided for in subsection 104(13.1) distributes the amount not deducted among all the beneficiaries. Thus, it is not possible to attribute to Marc the full amount of the dividend payable to him and have the share of the dividend attributed to Sophie taxed in the trust.

c. It is necessary to determine whether section 74.4 would apply, requiring that an amount of deemed interest be included in Patricia's income.

   Section 74.4 might apply if Holdco Ltd. loses its SBC status in the future. This is because
   - there is a transfer of property,
   - it is between an individual and a corporation, and
   - it is reasonable to consider that one of the main purposes of the transfer is to reduce Patricia's income and benefit someone who is a designated person (spouse or minor child) and a designated shareholder.

   However, section 74.4 does not apply so long as a corporation is an SBC. At the outset, Holdco Ltd. holds only shares of Youthglow Ltd. and qualifies as an SBC. However, it is possible that Holdco Ltd. will lose its SBC status in the future if an amount too large for investment purposes is kept in the corporation.

If section 74.4 applies, Patricia will be deemed to have received as interest, during the year in which all the conditions are met,

- an amount equal to interest calculated at the prescribed rate on the value of the unpaid note and the unredeemed preferred shares,

less the total of

- the amount of interest received on the note in the year by the individual;
- 5/4 of the taxable dividends received in the year on the preferred shares acquired as consideration for the transfer, except for the deemed dividends received under section 84;

and

- 5/4 of the taxable dividends received by the designated person if it is reasonable to consider that these dividends are part of the benefit that is intended to be conferred and if these dividends are included in the split income of the designated person.

d. Subject to certain conditions set out in subsection 107(2), the distribution of property on liquidation of the trust should not have negative tax consequences. However, the liquidation of the trust when Sophie turns 40 means that the trust will exist for 26 years. Under subsections 104(4) and 104(5), there will be a deemed disposition of the property of the trust at its fair market value on the 21st anniversary of the creation of the trust. If at that time the trust has property that has appreciated, there could be major tax consequences.

Case 2

Vicenzo Dezelaq and his sister Carole own respectively 40% and 60% of the 100 common shares of Jazz Ltd., a manufacturer of musical instruments.

They each inherited 40 shares in 1994 on the death of their father Frank. The FMV of the 80 common shares was set at $700,000 by the accountant and was accepted by CRA. At that time, Carole already had 20 common shares of Jazz Ltd., which she had purchased for $75,000 on the departure in 1990 of Ted, a person who deals with the Dezelaq family at arm's length.

Jazz Ltd. was incorporated in 1985. Frank had then subscribed $8,000 for 80 common shares, and Ted subscribed $2,000 for 20 common shares.

Carole and Vincenzo have trouble agreeing on the management of Jazz Ltd. Carole, being the majority shareholder, has proposed different scenarios to Vincenzo and is waiting for his comments. According to their accountant, the current FMV of the 100 common shares of Jazz Ltd. is $1,200,000.

Proposed scenarios:

1. Merger on November 1, 2008, with Blues Inc., a competitor whose common shares have a FMV of $800,000 and a PUC of $100,000.

   In such a case, Vincenzo would remain a shareholder but would no longer participate in the operations of Jazz Ltd. He would receive non-voting preferred shares redeemable at $480,000, providing a cumulative annual dividend of 5%. The PUC of the preferred shares would be $480,000.

   Carole and the shareholders of Blues Inc. would divide between them the 10,000 common shares that would be issued by the new corporation resulting from the merger, on the basis of the FMV of the shares that they hold in the two corporations. The PUC of the shares issued would be $10,000.

Blues Inc. has a non-capital loss balance of $50,000 from its fiscal period ended December 31, 2001. Blues Inc. has always had a December 31 year end.

Blues Inc. estimates that its taxable income would be $40,000 on October 31, 2008, and believes that it will easily reach $75,000 before the end of its fiscal period.

2. Redemption by Jazz Ltd. of Vincenzo's 40 shares for $600,000 on November 1, 2008

   Carole is prepared to pay a premium to get her brother out of the business. Also, Jazz Ltd. will enter a $50,000 debt to Vincenzo on its financial statements, for a retirement allowance that would be paid to him in August 2008 for his ten years of service.

Additional information:

1. Jazz Ltd. has never been able to qualify as an SBC, since it has always owned rental properties that represented approximately 60% of the FMV of the assets.
2. Jazz Ltd. has no general rate income pool (GRIP).
3. During the period ended December 31, 2007, Jazz Ltd. loaned $20,000 to Vincenzo to enable him to purchase shares of a public corporation. The loan was granted at the rate prescribed by the ITA at that time and must be repaid by December 15, 2008, with interest accrued for 2008. The interest payable for 2007 was paid on December 31, 2007.

Required

a. Determine all the tax consequences for Vincenzo depending on whether he accepts one or the other of the two scenarios proposed.
b. Describe the tax consequences for Carole.
c. Determine the tax consequences for Jazz Ltd. according to the two scenarios proposed.
d. State what treatment is available for the non-capital loss carried forward by Blues Inc. Explain what could have been done to lessen these consequences.

Solution

a. **Scenario 1**

   Merger of Jazz Ltd. and Blues Inc.

   Since the shares that Vincenzo held in Jazz Ltd. are capital property, and since the only consideration that he would receive in the merger is shares of the new corporation, he would be deemed under subsection 87(4) to have disposed of his shares for an amount equal to their ACB.

   Under paragraph 70(5)(b), the ACB of the 40 common shares held by Vincenzo is $350,000 ($700,000 × 50%), which is the FMV of the shares at the time of his father's death.

POD	$ 350,000
ACB	(350,000)
Capital gain	$ —

   When the legal PUC of the shares issued in the merger by the new corporation exceeds the PUC of the predecessor corporations, the excess reduces the PUC of the different classes of the shares of the capital stock of the new corporation. The reduction is distributed among the different classes of shares on the basis of their respective PUC.

PUC reduction [87(3)(a)]

Legal PUC of the new corporation	$ 490,000
Less: PUC of the predecessor corporations	(110,000)
Reduction of the PUC to be attributed to the common shares and the preferred shares	$ 380,000

PUC of the common shares

Legal PUC of the common shares	$ 10,000
Reduction: $\frac{\$10,000 \times \$380,000}{\$490,000}$	(7,755)
PUC of the 10,000 common shares	$ 2,245
PUC per common share	$ 0.2245

PUC of the preferred shares

Legal PUC of the preferred shares	$ 480,000
Reduction: $\frac{\$480,000 \times \$380,000}{\$490,000}$	(372,245)
PUC of the preferred shares	$ 107,755

The PUC of the preferred shares held by Vincenzo is therefore $107,755.

Loan to shareholder

Because of Jazz Ltd.'s deemed year end of October 31, 2008 as a result of the merger, Vincenzo would be obliged to repay his $20,000 loan no later than that date rather than by December 15, 2008 if he wants to avoid the implications of subsection 15(2).

Scenario 2

Redemption of the common shares by Jazz Ltd.

The PUC of the 40 common shares is $4,000, or 40% of the amount subscribed when Jazz Ltd. was incorporated. There has been no other issuance since then.

Deemed dividend

Amount paid on redemption	$ 600,000
PUC	(4,000)
Deemed dividend	$ 596,000

Under paragraph 82(1)(b), this amount must be grossed up by 1/4 when it is included in Vincenzo's income.

Even if Vincenzo receives more than the FMV of the shares on the redemption, a benefit cannot be considered to have been granted to a shareholder, since the share redemption by the corporation is one of the exceptions to the application of subsection 15(1).

Capital gain

POD (54)		
Amount received	$ 600,000	
Deemed dividend	(596,000)	$ 4,000
ACB		(350,000)
Capital loss		$(346,000)
Deductible capital loss (1/2)		$(173,000)

This loss cannot be considered to be a business investment loss under paragraph 39(1)(c), since Jazz Ltd. is not an SBC.

The loss will not be deemed to be nil under subsection 40(3.6), since Vincenzo is not a person affiliated with Jazz Ltd. as defined in subsection 251.1(1).

Loan to shareholder

Provided that Vincenzo repays the $20,000 loan as scheduled by December 15, 2008, subsection 15(2) will not apply, since the exception provided for in subsection 15(2.6) applies, the loan having been repaid in the year following the taxation year of the corporation during which the debt arose.

Although Vincenzo is no longer a shareholder of Jazz Ltd. following the redemption of the shares, this does not eliminate the possibility that subsection 15(2) will apply, since he continues to be a person connected with a shareholder. Under subsection 15(2.1), a person is connected with a shareholder if that person does not deal at arm's length with the shareholder, which is the case for Vincenzo.

Retiring allowance

Part of the retiring allowance that Vincenzo would receive could be transferred to an RRSP under the provisions of paragraph 60(j.1). Vincenzo could therefore defer a portion of the income taxes that would be payable on the retiring allowance.

b. **Scenario 1**

On the merger, Carole would receive 4,737 common shares. The FMV of the 10,000 common shares is $1,520,000, which is the total FMV of the two predecessor corporations, namely $2,000,000 ($1,200,000 + $800,000) reduced by the FMV attributed to the preferred shares that would be issued to Vincenzo.

The only tax consequence for Carole is in Scenario 1, where the PUC of the shares that she would hold in the new corporation following the merger would be $1,063.46 ($4,737 × $0.2245).

c. **Scenario 1**

When there is a merger, the taxation year of each of the predecessor corporations is deemed to end immediately before the merger. The merger on November 1, 2008 would move the year end of Jazz Ltd. to October 31, 2008.

Furthermore, under paragraph 256(7)(b), the control of Jazz Ltd. is deemed to have been acquired because Blues Inc., which now controls the new corporation arising from the merger, did not control Jazz Ltd. before the merger. There could therefore be tax consequences for the tax accounts of Jazz Ltd. that would normally be transferred to the

new corporation on the merger, including loss carryforwards or the immediate recognition of losses not yet incurred.

Scenario 2

Even though the retiring allowance is reported in the 2008 fiscal period of Jazz Ltd., it can only be deducted during the fiscal period of Jazz Ltd. ending December 31, 2009, since it will not have been paid within 180 days following the end of the fiscal period during which the expense was incurred, as provided in subsection 78(4).

d. **Scenario 1**

Since the fiscal period of Blues Inc. is deemed to end on October 31, 2008, because of the merger, an amount of $10,000 in the non-capital loss balance for 2001 is lost, since the seven-year carryforward period is extinguished with the end of this fiscal period. Since the estimated taxable income of Blues Inc. on December 31, 2008, would be sufficient to use the loss carryforward for 2001 in its entirety, the merger of the two corporations should take place on January 1, 2009.

Conclusion

As you have been able to observe throughout your studies, some provisions of the ITA are complex, and a number of them are interrelated. By drawing on the various concepts that you have explored, you should be able to carry out tax planning using provisions such as those concerning rollovers, reorganizations, partnerships, and trusts. Furthermore, ethics and professionalism must be elements of any tax planning engagement.