ESTATE FREEZES INVOLVING TRUSTS

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Trusts have a multitude of purposes and, in estate planning, can be used in conjunction with estate freezes to allow flexibility to the person initiating the freeze to allocate future growth on a discretionary basis to family members.

Where portfolio assets have grown in value and are expected to continue to do so, the use of a trust in an estate freeze must take into account a number of specific attribution rules throughout the Income Tax Act as well as the 21-year deemed disposition rule for trust property. Furthermore, where persons wishing to initiate a freeze own shares of a small business corporation the shares of which may qualify for the capital gains exemption, a number of opportunities exist not only to allow future growth to accrue to family members, but also to allow family members to access their capital gains exemption in the event that the shares of the operating company are sold.

This article reviews a number of provisions of the Income Tax Act specifically applicable to these types of estate planning. The article focuses on two typical freeze structures in order to reveal the practical applications of the various rules. One structure involves freezing shares of an operating company, ensuring that its shares remain qualified for the capital gains exemption and multiplying the exemption by allocating future growth to family members. The second structure focuses on a freeze involving a corporation with portfolio investments, which have grown and are expected to continue to grow in value. In each case, the emphasis will be on the use of trusts in the context of the estate freeze.

KEYWORDS: ATTRIBUTION ■ ESTATE FREEZES ■ INCOME SPLITTING ■ CAPITAL GAINS ■ TRUSTS ■ ESTATE PLANNING

INTRODUCTION

For those who have accumulated a portfolio of securities in their corporation, which have grown in value, estate freezes can be implemented with trusts to allow
the future growth of the portfolio to accrue to family members while allowing the freezeor to retain effective control over the assets, their distribution, and the distribution of profits.

In many closely held corporations, significant tax savings can occur with the use of the capital gains exemption available for up to $500,000 per individual on qualified small business corporation shares. Proper planning and monitoring can ensure that the shares qualify and remain qualified for the capital gains exemption. This can be useful in estate planning and presents interesting opportunities when implementing estate freezes. As well, with the use of trusts, the $500,000 exemption per individual can be multiplied by having family members or a family trust (for the benefit of family members) own shares. The use of trusts can also be part of a structure to ensure the ongoing qualification of the shares as qualified small business corporation shares.

While focusing on two typical estate freeze planning techniques using trusts, one where the corporation involved is active and the other where it owns portfolio securities, this article will review the various provisions of the Income Tax Act1 to be taken into consideration when implementing such structures, with an emphasis on how trusts can interact in the process.

**CAPITAL GAINS EXEMPTION FOR “QUALIFIED SMALL BUSINESS CORPORATION SHARES”**

Under the Act, in order for shares to qualify as “qualified small business corporation shares,”2 the corporation itself must be a “small business corporation”3 at the time of disposition of the shares and, in addition, a 24-month holding period requirement must be met. In general terms, a “small business corporation” can be defined as a “Canadian-controlled private corporation”4 that at the time of the disposition uses substantially all (generally 90 percent or more) of its assets in an active business carried on primarily in Canada or a holding corporation for a corporation that meets such test. This is an asset test only (liabilities are not considered) and is based on the fair market value of a corporation’s assets. A “Canadian-controlled private corporation” is essentially a private corporation5 that is not controlled by one or more non-residents or public corporations.

As well, during a holding period of 24 months prior to the disposition, at least 50 percent of the assets of the corporation must have been used principally in an active business carried on primarily in Canada or used to finance a similar qualifying corporation, which is “connected”6 to it within the meaning of the Act. However, where the disposition constitutes a disposition of shares of a holding corporation, which owns investments and fails the 50 percent asset test, then the connected subsidiary corporation must meet the above-mentioned 90 percent test throughout the 24-month holding period.

Furthermore, during the 24-month holding period prior to the disposition, the shares must not have been owned by anyone other than the shareholder or a person with whom the shareholder does not deal at arm’s length. Generally, shares issued
from treasury do not qualify unless they are issued in exchange for other shares or upon a transfer of a non-incorporated business.\textsuperscript{7} This in itself may present a planning opportunity in the context of a freeze where the freezor exchanges the bulk of his common shares (say 99 percent of them) for fixed-value retractable preference shares.\textsuperscript{8} The remaining common shares (that is, the 1 percent) can be sold at a nominal fair market value to a non-arm's-length person and the latter will benefit from the former's holding period for the purpose of the 24-month holding period.

**Planning Tip**

In the event of death, where the surviving spouse receives the shares from the deceased, the surviving spouse may immediately meet the 24-month test since he or she acquires the shares from a related person, provided that the deceased otherwise met the 24-month test. Thus, there is an opportunity to double up on the capital gains exemption. One must remember that, pursuant to subsection 70(6), the surviving spouse generally receives the shares on a tax-deferred rollover basis. One of the conditions is that the shares “vest indefeasibly” with the surviving spouse within 36 months after the death of the deceased spouse.\textsuperscript{9}

Consequently, if it is desirable for the deceased to use up his capital gains exemption, his legal representatives can then elect not to have rollover treatment apply to the surviving spouse on a sufficient number of shares to generate a capital gain for the deceased to use up his capital gains exemption. The surviving spouse would then receive some shares with a stepped-up adjusted cost base (that is, non-rollover) and other shares on a rollover basis, giving rise to an averaged adjusted cost base to the surviving spouse of the shares under the identical properties rules.\textsuperscript{10} In some circumstances, it might be appropriate for the provisions of the deceased’s will to allow this flexibility so that not all assets roll over to the surviving spouse.

The same planning opportunities exist where the shares of the deceased are bequeathed to a spouse trust\textsuperscript{11} established for the deceased’s spouse.

If useful, where the surviving spouse or spouse trust has common shares with such an averaged adjusted cost base, the spouse or spouse trust could transfer such shares back to the corporation under a section 85 rollover and take back both one class preference shares in an amount equal to the averaged adjusted cost base and, for the rest, common shares. The elected amount (and deemed proceeds of disposition) would be equal to the averaged adjusted cost base and the preference shares would have a fixed value equal to (and thus allocating to the class preference shares) such averaged adjusted cost base (that is, the elected amount), leaving (pursuant to paragraphs 85(1)(g) and (h)) nominal adjusted cost base to the new common shares taken back. This would have the effect of segregating the averaged adjusted cost base to the preference shares.

**Tips and Traps**

There are a number of traps that must be avoided. For example, the capital gains exemption may be reduced by an individual’s cumulative net investment losses
The use of the capital gains exemption may also cause the application of alternative minimum tax. It should be noted that alternative minimum tax does not apply to an individual for the taxation year in which that individual dies.

Furthermore, the value or the proceeds of a life insurance policy owned by the corporation could cause the corporation to fail the asset test for purposes of qualifying the shares for the capital gains exemption. In general, the value of a life insurance policy or the proceeds thereon would not constitute an asset considered to be used in an active business carried on in Canada. However, there are exceptions where the life insurance is valued only at its cash surrender value (which is often quite nominal), to the extent that the proceeds of the life insurance policy are used directly or indirectly to redeem, acquire, or cancel the shares in question within 24 months of the death of the individual.

Even if the capital gain is exempt, the disposition must be reported in an income tax return in order for the exemption to be claimed. Problems could also arise where a significant portion of the capital gain for which the exemption is claimed is attributable to the fact that dividends were not paid on shares of the corporation.

**Multiplying the Capital Gains Exemption**

Planning opportunities exist where the freezor wishes to freeze the value of his or her current shareholdings and have the future growth accrue in a family trust for the benefit of family members.

Where the trust has disposed of shares that could qualify as qualified small business corporation shares, it may allocate the resulting taxable capital gains to its income beneficiaries so that they may access their respective capital gains exemptions. While a taxable capital gain may be income for income tax purposes, it is generally capital for trust law purposes, which means that it can be distributed only to a capital beneficiary and not to an income beneficiary. The provisions of the trust could be drafted to allow the trustees to treat a taxable capital gain as income for trust purposes and distribute such to an income beneficiary, or alternatively to grant an income beneficiary a contingent capital interest in the trust, allowing the trustees to distribute some capital (such as a taxable capital gain) to such an “income” beneficiary (in satisfaction of his contingent capital interest). This would allow an “income” beneficiary to access his capital gains exemption, which would not otherwise be available.

Alternatively, the family trust could allocate the future capital gains realized on its shares by distributing them on a tax-deferred basis to different capital beneficiaries (the freezor’s spouse and children, for example), who would each qualify for the $500,000 capital gains exemption, thereby multiplying the tax saving.

If a trust acquires the shares, it may also benefit from the transferor’s holding period of the shares, provided that the trust does not deal at arm’s length with the transferor. Where the trust so disposes of such shares, for the purpose of determining its 24-month holding period, subparagraph 110.6(14)(c)(ii) provides that a “personal trust” will be related to the person from whom it acquired qualified small business corporation shares if all of the beneficiaries (other than registered charities)
of the personal trust were related to that person or would have been so related if that person were living at that time.

This provision in itself may present a planning opportunity in the context of a freeze where the freezor exchanges the bulk of his common shares (say, 99 percent of them) for fixed-value retractable preference shares and sells or gifts the remaining common share(s) to the trust. In this scenario, the trust (or rather its beneficiaries) may benefit from the non-arm’s-length transferor’s holding period of the shares. This arrangement can be useful where a sale of the shares to a third party is imminent. Care should be exercised on the potential application of the reversionary trust rules in subsection 75(2) and the attribution rules in sections 74.1 through 74.5.

Where a trust has allocated capital gains to a beneficiary, subsection 104(21) provides certain rules that will allow the trust’s net taxable capital gains to be designated and retain such nature in the hands of a beneficiary. When such a designation is made, the trust can also make a further designation under subsection 104(21.2) in order that the taxable capital gains may also be eligible for the capital gains exemption. This mechanism will allow a beneficiary to use his capital gains exemption for qualified small business corporation shares.

Alternatively, where the trust has distributed qualified small business corporation shares on a tax-deferred basis pursuant to subsection 107(2) to one or more capital beneficiaries, the capital beneficiaries may realize a capital gain by selling the qualified small business corporation shares themselves. Where the capital beneficiary wishes to claim the capital gains exemption on a disposition of the qualified small business corporation shares, it is necessary for the share to have been owned by an individual (that is, the beneficiary) throughout the 24 months immediately prior to the disposition, or by a person or partnership related to the individual. Pursuant to subparagraph 110.6(14)(c)(i) for purposes of the definition of “qualified small business corporation share,” a personal trust is deemed to be related to a person or partnership for any period throughout which the person or partnership was a beneficiary of the trust. (Pursuant to the same definition, the share must be owned by an individual including a “personal trust” but not any other kind of trust.) Furthermore, recently enacted paragraph 251(1)(b) provides that a trust and a taxpayer will be deemed not to deal at arm’s length if the taxpayer or a person not dealing at arm’s length with the taxpayer is beneficially interested in the trust. Accordingly, the beneficiary may benefit from the period of time during which the trust owned the shares for the purpose of the 24-month holding period.

Purifying and Maintaining the Status of the Corporation So That Its Shares Qualify as “Qualified Small Business Corporation Shares”

When non-active business assets in a corporation prevent it from qualifying as a “small business corporation” or its shares from qualifying as “qualified small business corporation shares,” purification techniques will need to be utilized to extract such non-active business assets.
One technique would be for the shareholder to transfer on a tax-deferred basis to a separate corporation sufficient shares of the main corporation that is to be purified, equal in value to the non-active business assets to be extracted. These transferred shares would then be redeemed (potentially giving rise to intercorporate deemed dividends), and in payment therefor, the main corporation would transfer the non-active business assets to the separate corporation (giving rise potentially to a taxable transaction for the main corporation). Dividends received by a corporation are generally deductible from its income, subject to the potential application of section 55, which is discussed later.

Another technique is to have the main corporation transfer such non-active business assets to the separate corporation on a tax-deferred rollover basis in exchange for shares of the separate corporation. A sufficient number of shares of the main corporation equal to the value of the assets to be extracted (and equal in value as well to the shares just issued by the separate corporation for the non-active business assets) would then be transferred by the shareholder(s) of the main corporation to the separate corporation on a tax-deferred rollover basis (as shown in figure 1).

Each set of intercorporate shares (between the separate corporation and the main corporation) would then be redeemed, resulting in a “butterfly”-type transfer of the non-active business assets to the separate corporation (again, potentially giving rise to intercorporate deemed dividends).

When a trust is used in estate planning, the separate corporation could be a beneficiary. The status of the shares of the main corporation as “qualified small business corporation shares” may also be maintained on an ongoing basis by having the main corporation pay out to the trust (as shareholder) in the form of a dividend its non-active business assets from time to time (potentially on a taxable basis to the main corporation), which would then distribute such assets (such as cash) to the separate corporation as an allocation of dividend income to an income beneficiary (as shown in figure 2).

Dividend income received by the trust would generally be included in its income. The trust would generally deduct such dividends when they are paid or payable to an income beneficiary such as the separate corporation. To the extent provided for in subsection 104(19), the dividend income, which is allocated to an income beneficiary, may retain its nature in the hands of the beneficiary such as the separate corporation. Dividends received by a corporation are generally included in its income, and the recipient separate corporation would generally seek the deductibility of such dividends from its income.

**Section 55 and Intercorporate Dividends**

Care must be exercised so that these purification techniques do not occur as part of a series of transactions or events to which the anti-avoidance rules of subsection 55(2) may apply, or which may have avoided those rules owing to the exception found in paragraph 55(3)(b). Subsection 55(2) is designed to recharacterize as proceeds of disposition (potentially giving rise to capital gains) what would otherwise
be tax-free intercorporate dividends. Paragraph 55(3)(b) prevents such rules from applying in certain arm’s-length butterfly reorganizations.

Where the recharacterization of intercorporate dividends as proceeds of disposition has been avoided because the reorganization has been carried out using a butterfly reorganization (under paragraph 55(3)(b) in an arm’s-length situation), paragraph 110.6(7)(a) will deny the use of the capital gains exemption for qualified small business corporation shares.

Section 55 will also not apply, pursuant to paragraph 55(3)(a), where the reorganization does not result, as part of a transaction or series of transactions or events, in a disposition to an unrelated person. This provision allows reorganizations among non-arm’s-length persons where intercorporate dividends are created in the course of the reorganization. Nonetheless, difficulties can arise in situations involving family members since, for example, brothers and sisters are treated as dealing at arm’s length for purposes of subsection 55(2). In this respect, there are also specific provisions for trusts. A person and a trust will be considered to be related at any time where the person is related to each beneficiary under the trust
and such beneficiary/beneficiaries is/are entitled to a share of income or capital from the trust (other than by reason of death of another beneficiary). 29 Furthermore, a person and a trust will be deemed not to be related 30 unless

- they meet the “related” criteria set out above;
- where an individual is a beneficiary under a personal trust (within the meaning assigned by subsection 248(1)) and acquires a share (of a corporation) on a capital distribution by the trust, the beneficiary will be treated for the purposes of section 55, in respect of that acquisition, as being related to the trust; 31 or
- where the person is a corporation, it is controlled by the trust.

**Part IV Tax**

Part of the success of these purification techniques rests on the deductibility for the corporate recipient of intercorporate dividends. In this regard, a corporate recipient of a dividend may also be subject to part IV tax. 32 However, there are two exceptions where part IV tax will not apply to a corporate recipient where it and the payer corporation are “connected.”

The first exception applies where the corporation paying the dividend is controlled by the receiving corporation. However, the concept of control has a specific definition for the purpose of part IV tax and provides that the paying corporation will be controlled by the receiving corporation if more than 50 percent of the issued share capital of the payer corporation having full voting rights under all circumstances belongs to either:

- the receiving corporation;
- persons with whom the receiving corporation does not deal at arm’s length; or
- a combination of the receiving corporation and persons with whom the receiving corporation does not deal at arm’s length.

Consequently, in order to ensure that dividends paid by the “paying” main corporation to the trust, which are then allocated to the separate corporation, remain free of part IV tax to the recipient separate corporation, there should be control by the separate corporation of the main corporation by way of a sufficient number of voting shares, or both corporations should be controlled by the same person or persons with whom the receiving corporation does not deal at arm’s length. This may be arranged by having the payer main corporation issue a class of nominal value voting preference shares, sufficient in number for the receiving separate corporation and/or persons who do not deal at arm’s length with the receiving separate corporation to control the payer main corporation. 33

Alternatively, if the trust were to control the payer main corporation, the application of recently enacted paragraph 251(1)(b) may provide an opportunity to exempt the receiving separate corporation from part IV tax to the extent that the trust controls the payer main corporation and does not deal at arm’s length with the
receiving separate corporation. Recently enacted paragraph 251(1)(b) provides that a trust and a taxpayer will be deemed not to deal at arm’s length if the taxpayer or a person not dealing at arm’s length is beneficially interested in the trust. The payer main corporation would then be controlled by a person (that is, the trust), that does not deal at arm’s length with the receiving separate corporation. The test would also be met if the payer main corporation were controlled by a combination of the trust in such circumstances and a person or persons with whom the receiving separate corporation does not deal at arm’s length.

The second exception to part IV tax applies where the receiving corporation owns at the time it receives the dividend:

- more than 10 percent of the issued share capital (having full voting rights under all circumstances) of the payer corporation; and
- shares of the capital stock of the payer corporation having a fair market value of more than 10 percent of the fair market value of all of the issued shares of the capital stock of the payer corporation.

To meet the second exception, the receiving separate corporation would need to own sufficient shares to meet the 10 percent votes and value test described above. There are no provisions in this second exemption in part IV that create any presumption benefiting the separate corporation from being notionally attributed ownership of any of the shares of the main corporation owned by the trust. Consequently, unless the separate corporation owned directly sufficient shares in the main corporation to meet the 10 percent votes and value test, the second exception would be more difficult to structure.

In any event, when either of the exceptions is met, the corporations are found to be “connected” and, generally, part IV tax would not apply. However, the receiving corporation may nevertheless be subject to part IV tax where the payer corporation has received a dividend refund out of its refundable dividend tax on hand (RDTOH). For example, if the payer corporation has RDTOH, a payment of a taxable dividend will entitle it to a refund of RDTOH at the rate of $1.00 of refund for every $3.00 of taxable dividend paid. Conversely, in such a situation when the receiving corporation is connected with the payer corporation, the receiving corporation will nonetheless be subject to part IV tax equal to its proportion of the payer corporation’s refund of RDTOH among the shareholders receiving dividends (based on their share of the total dividends paid). Such part IV tax will in turn be added to the receiving corporation’s own RDTOH.

**ATTRIBUTION RULES**

When implementing an estate freeze using family members or family trusts to maximize the use of capital gains exemptions, one must be mindful of the attribution rules contained in the Act and their potential application to the particular situation.
The Act provides certain attribution rules with respect to property transferred by an individual to his or her spouse, or to non-arm’s-length minors. Generally, the rules are designed to prevent a taxpayer from splitting income among family members and thereby reducing the total amount of tax payable. These rules also apply when trusts are used to attempt to split income with other members of the family. Generally, these rules will require that the income and/or capital gains from property transferred be treated for tax purposes as income and/or capital gains of the transferor.

**Subsection 74.1(1): Income Attribution Involving Spouses**

When an individual has lent or transferred property, either directly or indirectly, including by way of a trust, to another person who is or has become his or her spouse, any income or loss derived from such property, or from property substituted therefor, is attributed back to the individual for the period throughout which the individual is resident in Canada.

**Subsection 74.2(1): Attribution of Capital Gains/ Losses Involving Spouses**

When an individual has lent or transferred property, either directly or indirectly, including by way of a trust, to another person who is or has become his or her spouse, the taxable capital gains and the allowable capital losses derived from such property, or from property substituted therefor, are attributed back to the individual for the period throughout which the individual is resident in Canada. While this specific attribution rule applies to spouses, it does not apply to minors.

**Subsection 74.1(2): Income Attribution Involving Minors**

Pursuant to subsection 74.1(2), when an individual loans or transfers property, either directly or indirectly, including by way of a trust, to persons who are under 18 years of age and who are either the niece or nephew of the individual or minors who do not deal at arm’s length with the individual (such as his or her children), any income or loss derived by the minor from the property, or from property substituted therefor, is attributed back to the individual for the period throughout which the individual is resident in Canada unless the minor has attained the age of 18 years before the end of the year. As noted above, capital gains are not attributed back to the individual when minors are concerned, in contrast to the treatment in the case of a spouse.

**Subsection 74.3(1): Attribution Rules Involving Trusts**

Subsection 74.3(1) provides rules to adapt the above-described attribution rules to situations where an individual has transferred or loaned property, either directly or
indirectly, to a trust in which a “designated person” (essentially the individual’s spouse or a person under the age of 18 who does not deal at arm’s length with the individual or who is his or her niece or nephew) is beneficially interested and with respect to income or capital gains paid or payable to such a “designated person” by the trust.

**Transfers for Fair Market Value**

The above attribution rules can be avoided where the individual receives fair market value for the property transferred or where the individual receives indebtedness that bears interest at a rate equal to the lesser of

- interest at the prescribed rate when the indebtedness was incurred; and
- an arm’s-length interest rate (having regard to all circumstances at the time the indebtedness was incurred).

Similar rules apply where the individual made a loan that bears interest. The interest must be paid within 30 days after the end of the relevant year and have been paid no later than 30 days after the end of each previous year.

Given that currently commercial and prescribed interest rates are relatively low, this alternative (of paying interest) may be advantageous in a freeze situation if the long-term growth of the assets is expected to outperform such interest rates.

**Section 74.4: Imputation Rules Involving Corporations**

While not an attribution rule per se, section 74.4 provides imputation rules where an individual loans or transfers property to a corporation for the benefit of “designated persons” (essentially the individual’s spouse or a person under the age of 18 who does not deal at arm’s length with the individual or who is his or her niece or nephew). There is also a motive test that must be met in order for these rules to apply. One must find that the main purpose of the loan or transfer may reasonably be considered to reduce the income of the individual and to benefit the other person or persons. Where these rules apply, the individual will be considered to have received interest income during the period(s) throughout which the persons qualified as “specified shareholders” of the corporation (basically, a shareholder who owns 10 percent or more of the shares of any class of the corporation, either directly or through a trust or partnership). These imputation rules apply whether or not any amounts are in fact paid to designated persons.

The amount imputed to the individual under section 74.4 is reduced by any interest received in the year on the loan to the corporation and eliminated if the individual receives interest in the year on his loan to the corporation, which is equal to the prescribed rate. In the case of shares, the amount imputed under section 74.4 is reduced by an amount equal to 125 percent of any dividends received in the year on the shares held by the individual and can be eliminated if the individual received dividends in the year on his shares equal to 80 percent of the prescribed rate.
The imputation provisions of section 74.4 do not apply during the period in which the corporation involved qualifies as “a small business corporation” (or becomes so qualified after it is sufficiently purified of non-active business assets that would prevent it from so qualifying).

One structure that could be used to benefit from this exception would be for the trust to own shares of a “small business corporation.” A separate corporation (to own non-active business assets) could be a beneficiary of the trust. The small business corporation could, from time to time on an ongoing basis, pay out to the trust as dividends sufficient non-active business assets that would otherwise eventually prevent it from qualifying as a “small business corporation,” thus maintaining its status and avoiding the imputation provisions of section 74.4 (since the section 74.4 imputation rules do not apply while the corporation involved qualifies as a “small business corporation”). The trust would then distribute (and deduct from its income) such dividends to the separate corporation, which would receive the dividends as tax-free intercorporate dividends.

Where there is a sufficient number of shareholders, the imputation provisions of section 74.4 will not apply with respect to shareholders who each own less than 10 percent of the shares of any class of the corporation.

Another technique that could be used to circumvent the imputation provisions of section 74.4 rests on the fact that section 74.4 applies when an individual (as opposed to a corporation) loans or transfers property to a corporation. Consequently, if an individual owns a corporation that does not qualify as a “small business corporation,” rather than having a trust (for the benefit of his family) own the shares of that corporation, the corporation in question would transfer growth or income-producing assets to a subsidiary on a tax-deferred basis in exchange for fixed-value rollover preference shares. The trust would subscribe for common shares from treasury of the subsidiary, and future growth or income would accrue to the trust (as shown in figure 3). It could be argued that section 74.4 would not impute income to the individual transferor because the transferor (or lender) of the assets to the subsidiary was not an individual, as is required by section 74.4, but a “corporation.”

As well, the deeming provisions of section 74.4 will not apply if the trust deed specifically prohibits a distribution or loan, etc., to a beneficiary while that person is a “designated person” within the meaning of the Act (essentially the individual’s spouse or a person under the age of 18 who does not deal at arm’s length with the individual or who is his or her niece or nephew). Such a prohibition, however, will prevent the trust from distributing (and thus deducting from its income) any income that would otherwise be payable to such excluded beneficiaries. The typical wording used in a trust deed would read as follows:

**Restrictions of Rights of Beneficiaries:**

Notwithstanding any provisions to the contrary, no Beneficiary shall be entitled to receive and the Trustees shall not pay or allocate any income or capital of the trust or otherwise obtain the use of any of the income or capital of the Trust as long as the
Beneficiary is a designated person within the meaning of any law relating to income tax, including, within the meaning of subsections 74.4(4) and 74.5(5) of the Income Tax Act.

**Subsection 75(2): Reversionary Trusts**

Of particular interest where trusts are involved, subsection 75(2) provides that where a person such as a settlor transfers property to a trust under certain conditions, the income from such property including capital gains and losses is attributed back to the transferor. The trust in this arrangement is often known as a “reversionary” trust. These rules will apply in any of the following situations where property is held on condition that

- the property transferred to the trust or substituted therefor may revert to the transferor;
- the property or the property substituted therefor may pass to persons to be determined by the transferor subsequent to the creation of the trust; or
- the property may be disposed of only with the consent of, or at the direction of, that person while alive.

Subsection 75(2) applies to income or loss from *property* and not income or loss from a *business*. Hence, business income or losses do not get attributed back to the transferor. This is also the case under the section 74.1 to 74.5 rules. There is, however, no second level of attribution on income earned on funds that result from income that has already been attributed to the transferor. For example, if the property received by the trust is money, which is deposited in a bank account, the interest on the initial deposit is attributed back to the transferor, but the interest on the interest left to accumulate in the bank account will not be attributed back to
the transferor. This is why a non-income-producing asset (such as a gold or silver coin) is typically used to settle a trust, to avoid any argument that subsection 75(2) may apply to any income from such property contributed to the trust.

Subsection 75(2) applies only while the transferor is in existence (or alive) and does not apply while such transferor is not a resident of Canada.

One trap to avoid is found in subsection 107(4.1). Where subsection 75(2) may apply in relation to a trust at any time, subsection 107(4.1) will prevent any tax-deferred distributions of capital to capital beneficiaries of the trust under subsection 107(2) while the transferor is alive, other than to the transferor or his spouse. This denial of the tax-deferred distribution applies to all capital property of the trust and not only the property received from the transferor. Thus, when subsection 75(2) applies, all capital property of the trust has been so tainted.

It would be possible to limit the degree of control of a transferor over property he transfers to a trust and thus avoid the application of subsection 75(2), by providing in the terms and conditions of the trust that where the transferor is one of the three (or more) trustees to the trust, all decisions are to be taken by a majority vote and not a unanimous vote. In this fashion, the transferor, in his capacity of trustee, does not have control over the property of the trust.

Quite often, to support the argument that subsection 75(2) is not applicable, the terms and conditions of the trust deed will provide that any trustee who has transferred assets to the trust and would otherwise have a degree of control of such assets, either alone (in the event that the other trustees have delegated such power to him) or as one of the trustees of the trust, is removed from the decision-making process involving such assets. For example, one could typically include this type of clause in the trust deed:

1.1 Limitation on Certain Powers of the Trustees

Notwithstanding any provision of this Agreement, if and for so long as an individual (the “Transferor”) is serving as the sole Trustee or as one of only two Trustees, and the Trust Property includes property directly or indirectly received by this Trust from the Transferor or property substituted for it (the “Transferred Property”), then if and so long as subsection 75(2) of the Income Tax Act would otherwise apply, the Transferor shall not have the right to exercise the following powers:

1.1.1 any power of encroachment, advancement or appointment with respect to the Transferred Property,
1.1.2 any power of sale or disposition with respect to the Transferred Property, or
1.1.3 any power to designate any person to be a member of the Excluded Class,\footnote{51} and if there is more than one trustee, all such powers and discretions with respect to the transferred Property shall be exercised by the other Trustees. The foregoing provision shall not restrict or otherwise affect the powers of the Transferor in his capacity as Trustee with respect to the other property then forming part of the Trust Property nor, if applicable, in his capacity as an Appointor.\footnote{52}

Advisers or drafters can alert the parties involved to this issue (and possibly form the basis of an argument that the transferor cannot validly transfer assets to
the trust) by providing in the terms and conditions of the trust deed that any such potential transferor (who should be named or referred to with the use of a definition) is prohibited from transferring assets to the trust, that the trust cannot accept any assets from such a person, and that any such purported transfer is null and void. One would argue that subsection 75(2) does not apply since no valid transfer of property has occurred.

Subsection 75(2) also presents difficulties where a person sells an asset to a trust and retains some degree of control—for example, the right to claim the asset back if the purchase price is not paid in full by the trust.

In the decision No. 40 v. Minister of National Revenue, the Tax Appeal Board held that the agreement between the appellant and his sons purporting to sell them his shares in a company was not the creation of a trust, but a sale. The agreement provided that the shares were to be held by a trustee until the purchase price was fully paid, and in default of payment, the shares were to revert back to the appellant. The court held that the trust feature was only incidental to the sale; under the agreement, the reversion of the shares to the vendor could occur only if a default payment was made by the purchasers. Such a stipulation was common to most sale agreements, and subsection 75(2) was not applicable.

At the 1991 Canadian Tax Foundation Revenue Canada round table, the Canada Customs and Revenue Agency (“the CCRA”) commented on a situation where a person sells income-producing property (for example, shares) to a trust, and the purchase price for the property is not paid immediately but is evidenced by a non-interest-bearing promissory note payable on demand. The CCRA went on to state that other forms of indebtedness—for instance, the unpaid purchase price of property sold to a trust—do not constitute loans and are not subject to the comments on loans. The terms of the indebtedness will, however, be relevant in determining whether a transfer of a property constitutes an unconditional bona fide sale. Where there is a bona fide sale, the fact that the purchase price is unpaid, will not, in and by itself, result in the application of subsection 75(2).

These positions will ordinarily apply whether or not the person making the loan or selling the income-producing property is the settlor of the trust, the sole trustee of the trust, or both.

In a CCRA technical interpretation dated July 17, 2000, one of the issues discussed was whether subparagraph 75(2)(a)(i) of the Act applied to dividends on shares transferred to a trust from a beneficiary in exchange for a non-interest-bearing demand note with no scheduled terms of repayment. The CCRA reiterated its view expressed at the 1991 annual conference regarding the application of subparagraph 75(2)(a)(i) to a bona fide sale of property; however, it stated that “when the terms of the trust are such that there is a possibility, however remote, that the person who transferred the property to the trust may reacquire the property (or property substituted for such property), subsection 75(2) applies notwithstanding that the person may have received consideration equal to the fair market value of
the property so transferred.” The CCRA added that since the individual was benefici-

The CCRA added that since the individual was beneficially interested in the trust within the meaning of subsection 248(25) of the Act and the shares transferred could conceivably revert back, the comments made at the 1991 annual conference do not apply and subsection 75(2) applies to any income earned by the trust on the shares (or property substituted for the shares).

Furthermore, in a technical interpretation dated June 26, 1992, the CCRA stated that “[a] sale at fair market value is considered a transfer and may be subject to subsection 75(2) of the Act. Subsection 75(2) of the Act applies where under a trust agreement, the trust property may revert back to the transferor or the property cannot be disposed of without the transferor’s consent.”

Therefore, it appears that where there is a sale at fair market value, subsection 75(2) would nonetheless apply where the property can return to the vendor. Otherwise, a mere indebtedness resulting from the unpaid purchase price in a bona fide sale of property to the trust would not attract the application of subsection 75(2).

Consequently, the prudent approach would be for the transferor to sell the asset to the trust in a bona fide sale, and not be a beneficiary of the trust, and if possible, not have any degree of control over the distribution of the asset by the trust.

Where the transferor or the freezor wishes to be a beneficiary of the trust, he should not contribute any assets to the trust by way of transfer or sale. A freezor might conceivably want to be part of the class of beneficiaries of the trust in the event that he wishes to effect a “thaw” that would mean at a later date distributing (by way of a tax-deferred distribution to a capital beneficiary) to the freezor the shares that have grown in value since the freeze. If the freezor is a beneficiary of the trust, the shares that have grown in value since the freeze can thus return to him. This strategy has the effect of “thawing” or undoing the freeze and returning the increase in value since the freeze back to the freezor.

**Subsections 56(4.1) to (4.3)**

Subsections 56(4.1) to (4.3) provide other attribution rules designed to reduce income-splitting strategies in situations where the attribution rules of section 74.1 are not applicable. Subsections 56(4.1) to (4.3) are of much broader application since they apply to loans and indebtedness between non-arm’s-length persons. The latter term covers a greater number of individuals than those envisaged by section 74.1, which is generally restricted to spouses, non-arm’s-length minors, and minor nephews and nieces.

Generally, subsections 56(4.1) to (4.3) apply to loans or indebtedness between non-arm’s-length individuals. Where applicable, income earned on the property (or property acquired from the proceeds of the indebtedness or substituted property) will be attributed back to the creditor. However, there is a motive test. For such attribution rules to apply, it is necessary that it be reasonable to consider that one of the main reasons for making the loan or incurring the indebtedness was to reduce or avoid tax by causing income from the loaned property, property that the loan or indebtedness enabled the particular individual to acquire, or property substituted therefor, to be included in the income of the particular individual.
These rules will not apply to capital gains or business income. They will also not apply, pursuant to subsection 56(4.2), where the loan or indebtedness bears a commercial rate of interest that is the lesser of a prescribed rate (under regulation 4301) at the time the loan was made and the rate of interest that would be negotiated between arm’s-length parties. Such interest must also be paid within 30 days following the year and each preceding year where interest was payable.

In the context of an estate freeze, this rule could apply where funds are loaned, for example, between brother and sister. Further, if interest is paid to avoid the attribution rule, this may defeat the objective of the freeze since future growth (to benefit a party) will be reduced by the interest paid.

**TWENTY-ONE-YEAR RULE FOR TRUSTS**

Trusts are generally deemed to dispose of their capital property (and land included in the inventory of a business) every 21 years. For trusts created prior to 1972, the first deemed disposition occurred on January 1, 1993. There were transitional measures that delayed this deemed disposition in circumstances where there were “exempt beneficiaries,” but those rules were eliminated; as a result, pre-1972 trusts were deemed to have disposed of their trust properties at the latest at January 1, 1999. However, in the case of spouse trusts, the disposition is postponed to the date of death of the spouse.

In estate-planning situations, the use of a trust to own shares of a corporation that has portfolio assets or qualifies as a small business corporation may require the trust to distribute its assets on a tax-deferred basis to its beneficiaries prior to its 21st anniversary (to avoid the deemed disposition). The freezor who implemented the estate plan (or freeze) may wish for the structure to continue beyond the first 21 years.

One solution is for the trust to exchange its common shares (with accrued gains) of the corporation on a tax-deferred rollover basis for fixed-value preference shares and subscribe for new common shares. The trust would then distribute the preference shares prior to its 21st anniversary to its capital beneficiaries on a tax-deferred basis in partial satisfaction of the beneficiaries’ capital interests in the trust. (The trust’s new common shares should have little value at its 21st anniversary.) The distribution would be a distribution of capital by a trust pursuant to authority to make such a distribution granted to the trustees (under the terms of the trust deed), such as a power to encroach.

The original freezor, however, may not want the capital beneficiaries to own preference shares of the corporation since such shares would most likely be retractable at the option of the holder (that is, the capital beneficiary). This option may give rights to the capital beneficiaries that the freezor is not willing to grant. The original freezor may wish the trust to continue controlling the assets or he may wish to have such control.

One alternative is for the trust to implement the above plan (that is, the trust would exchange its common shares for preference shares and subscribe for new common shares, prior to the 21st anniversary) but transfer on a rollover basis the
newly acquired preference shares of the main corporation to a new corporation in exchange for non-voting common shares. The trust would subscribe for nominal fixed-value voting preference shares of the new corporation to enable it to control the new corporation at all times (and indirectly its underlying assets, being the preference shares of the main corporation).

The trust would then distribute the non-voting common shares (having a low adjusted cost base but high value) of the new corporation on a tax-deferred basis to its capital beneficiaries prior to the 21st anniversary (as shown in figure 4). The capital beneficiaries would then own non-voting common shares of the new corporation, whose sole assets are the preference shares of the main corporation, without having effective control over the new corporation. Future growth of the main assets of the corporation would accrue to the trust, which would have effective control over the growth assets.

In this scenario, the trust (and thus its trustees) remains in control of the main corporation as well as the new corporation. This arrangement may be preferable where the parties wish the trustees to retain control.

Alternatively, the original freezor could be issued sufficient voting, nominal value preference shares of the main corporation and the new corporation, enabling him to control both at all times.

**TYPICAL STRUCTURES**

**Estate Freeze Involving a Small Business Corporation**

Where the freezor is involved with an active business operated in a corporation, the estate plan should maximize the availability of the capital gains exemption for qualified small business corporation shares and the avoidance of the section 74.4 attribution rules where small business corporations are involved. Typically, the principal is the sole shareholder of an operating company (“Opco”). He began Opco a number of years ago with a nominal investment in common shares, which has grown in value to, say, $2,500,000. His goal is to allow the future growth of Opco to accrue to a family trust of which he, his spouse, and his children are the main intended beneficiaries. To achieve this objective, he needs to “purify” Opco so that 90 percent of the fair market value of its assets is attributable to a business carried on primarily in Canada.

The freezor would exchange, on a tax-deferred basis, his existing common shares of Opco for 2,500,000 preference shares of Opco, having a fixed value of $2,500,000. New non-voting common shares would be issued to a family trust. He could then transfer 2 million of these preference shares to a newly incorporated holding company (“Holdco”). Holdco would be used to receive non-active business assets from Opco (upon redemption of a sufficient number of the latter’s shares held by Holdco), which would otherwise disqualify the shares of Opco for the capital gains exemption. While the family trust is discretionary, the intended income and capital beneficiaries of the family trust would be the freezor himself, his spouse, his
children, and Holdco. (If the freezor is a beneficiary, subsection 75(2) must be taken into account.) In this manner, the non-qualifying assets in Opco can be paid out as a dividend to the family trust, which would then distribute such assets to Holdco. (There are a number of technical issues that must be considered, such as part IV tax under the Act.) The freezor would keep $500,000 worth of preference shares of Opco. Consideration could be given to having the freezor exchange this $500,000 of preference shares with Opco under section 85 and crystallize the capital gains. In the event that Opco shares received on the exchange are sold to a third party, he could receive the full advantage of the capital gains exemption on the sale of those preference shares by receiving cash from a third party while using the capital gains exemption.

The trust would borrow funds from an arm’s-length third party (such as a bank) and would subscribe for non-voting common shares of Opco for nominal consideration. The freezor would be issued sufficient voting preference shares of Opco for nominal consideration to give him control of both Opco and Holdco (thus avoiding part IV tax issues). The trustees of the family trust would be the freezor himself as well as a third party (or parties). When qualified, shares of the freezor in Opco could be crystallized to secure the capital gains exemption.

To allow the trust to benefit from the freezor’s holding period of his shares, the freezor could consider retaining a minimal amount of common shares and selling them outright at a nominal fair market value or gifting them to the trust. A trust, which would not deal at arm’s length with the freezor, could benefit from the freezor’s holding period for the purpose of calculating the 24-month holding period. In such an instance, the freezor could not be a beneficiary of the trust, nor should he control its assets because of subsection 75(2) (see figure 5).
Estate Freeze Involving a Non-Small Business Corporation

Where the freezor is involved in a corporation with accrued value portfolio assets, the shares of which would not qualify as qualified small business corporation shares, or the corporation itself does not qualify as a small business corporation (which is relevant for the section 74.4 imputation rules involving corporations), the typical structure will require modification from the previous one involving a small business corporation.

It will most likely not be necessary to set up a separate corporation to receive non-active business assets since the main corporation will not need to preserve the status of a small business corporation. Consequently, the freezor will want to freeze the current value of his shares in the main corporation and allow the future growth to accrue to family members. He will enter into a typical freeze and exchange common shares for rollover preference shares of the same corporation. New non-voting common shares would be issued from treasury to a family trust. While the family trust may be discretionary, the intended income and capital beneficiaries of the family trust would be the freezor’s spouse, children, etc., and the freezor himself. (In the latter case, subsection 75(2) should not apply provided that the freezor has not transferred assets to the trust.) The freezor would typically wish to receive a sufficient number of voting nominal value preference shares to control the main corporation.

Section 74.4, which involves corporations, would impute an amount on a loan or shares as being received as interest on the preference shares held by the freezor in the corporation. One way to avoid section 74.4 is to pay an amount of interest every year equal to the amount of the prescribed rate or sufficient dividends. The alternative is to exclude from the potential class of beneficiaries under the terms
of the trust, any beneficiary who is a “designated person” (essentially the freezor’s spouse, or a person under the age of 18 who does not deal at arm’s length with the freezor or who is his or her niece or nephew). By this exclusion (illustrated in figure 6), the section 74.4 imputation rules will not apply, but the trust will be prevented from distributing income and capital to such “designated persons.”

**Issues Common to Both Types of Estate Freeze**

To ensure ultimate control of the trust, the freezor could (as “appointor”) be entitled to appoint and replace the trustees of the trust.

In either scenario, if the freezor wishes to carry out a freeze by freezing the bulk of his common shares and selling or gifting his remaining common share(s) to the trust, then, to avoid the reversionary trust rules of subsection 75(2) and the attribution rules, the freezor should not be a beneficiary of the trust because he will have contributed assets to the trust.

If the freezor has not contributed and will not contribute any assets to the trust, he can be a beneficiary under the trust (since subsection 75(2) would not apply).

To avoid the attribution rules, the trust should subscribe for common shares of the corporation (issued from treasury) using funds obtained from a loan from a bona fide arm’s-length third party, such as a bank. In this fashion, the freezor will not have contributed to the trust the initial sums used to pay for the new common shares, and thus the attribution rules and the subsection 75(2) rules will be avoided.

**SUMMARY AND CONCLUSION**

While many situations lend themselves to a “standard” estate freeze, the various interactions between the qualification of the corporation as a small business corporation, the attribution rules, and the 21-year rule for trusts may alter the various structures significantly.

The degree to which the freezor is willing to relinquish his ultimate control over the assets of the corporations remains an issue. To avoid certain attribution rules, it
may be necessary for the freezor not to have direct control over the trust itself, and this may present an issue. However, as we have seen, he can retain effective control by being granted sufficient voting rights in the various corporations to control the underlying assets and by becoming the appointor to the trust, whereby he retains the power to replace and nominate the trustees.

When dealing with “small business corporations,” a number of attribution rules can be avoided by purifying such corporations and maintaining their status as small business corporations. The use of a trust with a separate corporation as a beneficiary of such trust can achieve these goals. This separate corporation receives all non-active business assets. Furthermore, the beneficiaries of the trust may also benefit from the capital gains exemption on the shares of the small business corporation either by having the trust allocate capital gains generated by the sale of such shares to its income beneficiaries, or by distributing such shares to its capital beneficiaries on a tax-deferred basis (prior to a sale to a third party), thereby multiplying the $500,000 capital gains exemption among various beneficiaries. In either case, the 24-month holding period necessary for the qualification of qualified small business corporation shares can be achieved with the various rules involving non-arm’s-length transfers to and from a trust. For example, where the trust receives shares from a transferor, it may benefit from the transferor’s holding period of such shares for purposes of computing the 24-month holding period for qualified small business corporation shares. As well, the beneficiaries may benefit from the trust’s holding period of such shares for the computation of their own 24-month holding period for qualified small business corporation shares.

The purification techniques using a separate corporation often involve circumventing the section 55 intercorporate dividend rules, which would otherwise recharacterize the intercorporate dividends generated by the purification techniques as proceeds of disposition that may give rise to capital gains. Part IV tax is also an issue in intercorporate dividends.

The attribution rules, imputation rules, and subsection 75(2) rules are also relevant when structuring estate freezes with trusts to avoid attributing the trust’s income back to the freezor. This may mean preventing the transferor having control over the assets of the trust from transferring assets to the trust or contributing funds to the trust; or, in other circumstances, providing in the terms and conditions of the trust that income and capital distributions are prohibited to certain classes of beneficiaries such as “designated persons.”

Eventually it will be necessary to deal with the 21-year rule where the freezor intends the structure to continue past the 21 years. This may mean using certain structures analyzed in this article to avoid the 21-year rule while having the trust remain in control of the underlying assets, or alternatively continuing the freezor’s control over the underlying assets.
NOTES

1 RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as “the Act”). Unless otherwise stated, statutory references in this feature are to the Act.

2 See the definition of “qualified small business corporation share” in subsection 110.6(1).

3 Defined in subsection 248(1).

4 Defined in subsection 125(7) in accordance with subsection 248(1).

5 Defined in subsection 89(1) in accordance with subsection 248(1).

6 Within the meaning of subsection 186(4).

7 See paragraph 110(14)(f).


10 See section 47.

11 “Spouse trust” here refers to a trust that meets the requirements of subsection 70(6), essentially a trust created by a taxpayer’s will where the spouse is entitled to receive all income of the trust prior to the spouse’s death and no one but the spouse may receive or otherwise obtain the use of any of the trust’s income or capital prior to the spouse’s death.

12 See the definitions of “cumulative net investment loss,” “annual gains limit,” and “cumulative gains limit” in subsection 110.6(1).

13 See section 127.5 and following.

14 See section 127.55.

15 See paragraph 110.6(15)(a).

16 See subsection 110.6(6).

17 See subsection 110.6(8).

18 See supra note 8.

19 See its definition in subsection 110.6(1).

20 The concept of “beneficially interested” for these purposes has, pursuant to paragraph 251(1)(b), a modified meaning from the concept found under subsection 248(25).

21 Pursuant to subsection 84(3).

22 Subsection 112(1).

23 Ibid.

24 Paragraph 12(1)(j) and subsection 82(1).

25 Subsection 104(6).

26 Paragraph 12(1)(j) and subsection 82(1).

27 Subsection 112(1).

28 See subparagraph 55(5)(c)(i).

29 See subparagraph 55(5)(c)(ii).
30 See subparagraph 55(5)(e)(iii).
31 See also paragraph 55(3.2)(d).
32 Section 186 and following.
33 New subsection 186(7) was enacted to clarify that the meaning of the term “connected” for purposes of part IV tax (only) is to be determined using the specific definition of “control” found in subsection 186(2). This definition would not apply in respect of the concept of “connected” corporations occurring elsewhere in the Act.
34 See supra note 20.
35 Paragraph 186(4)(b).
36 Paragraph 186(1)(b) and subsection 129(3).
37 Section 129 and subsection 104(19).
38 Subsections 74.3(2) and 74.5(5).
39 See the concept of “beneficially interested” in subsection 248(25).
40 Paragraph 74.5(1)(b).
41 Subsection 74.5(2).
42 Subparagraphs 74.5(1)(b)(ii) and (iii) and paragraphs 74.5(2)(b) and (c).
43 Subsections 74.4(1) and 74.5(5).
44 See the definition in subsection 248(1).
45 Subsection 74.4(2).
46 See the definition in subsection 248(1). The requirements for a corporation to be a “small business corporation” are discussed above under the heading “Capital Gains Exemption for ‘Qualified Small Business Corporation Shares.’”
47 The intercorporate dividend concept is further discussed above under the heading “Purifying and Maintaining the Status of the Corporation So That Its Shares Qualify as ‘Qualified Small Business Corporation Shares.’”
48 The “designated person” must also be in essence a “specified shareholder” within a modified meaning from the concept found in subsection 248(1).
49 See supra note 8 for a description of the attributes of rollover preference shares.
50 Subsection 74.4(4).
51 “Excluded class” here is meant to refer to persons who are not and cannot be beneficiaries of the trust.
52 “Appointor” is meant to refer to the person who has the power to replace the trustees from time to time.
53 52 DTC 16 (TAB).
56 Ibid.
58 See subsection 104(4), which provides that certain properties are excluded from the deemed disposition.
59 Subsection 104(5.4).
60 “Spouse trust” here refers to a trust that meets the requirements of subsection 70(6), essentially a trust created by a taxpayer’s will where the spouse is entitled to receive all income of the trust.
prior to the spouse’s death and no one but the spouse may receive or otherwise obtain the use
of any of the trust’s income or capital prior to the spouse’s death.

61 Subsection 107(2).
62 See supra note 8.
63 Subsection 107(2).
64 See supra note 8.
65 Under section 85.
66 This mechanism is discussed above under the heading “Section 74.4: Imputation Rules
Involving Corporations.”