Common Tax Traps in Cross-Border Estate Planning

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**Reorganization which includes U.S. Tax Resident**

You have just been given instruction by your client and her advisors to implement a freeze of a family corporation with real estate interests and other investments. Shares of the family corporation are owned by all adult family members directly. It is contemplated that all family members will transfer their shares to a new holding company in exchange for fixed value preference shares. However, your client mentions nonchalantly that her daughter has been living in the United States for the past five years and would therefore be considered domiciled in the U.S. It is clear that the daughter holds an interest in what likely qualifies as a “passive foreign investment corporation” (“PFIC”) for U.S. tax purposes. Furthermore, assuming you had proceeded with the freeze, the section 85 rollover by the U.S. resident may not qualify for tax free treatment as a non-recognition transaction under Section 351 of the Internal Revenue Code due to certain of the requirements that must be met in order to qualify under that provision. Even if the daughter does not participate in the reorganization, she would be subject to the PFIC regime, which could apply to cause her to be subject to punitive tax consequences if she sells her shares or receives a distribution from the PFIC. The daughter could make a “qualified electing fund” election (known as a “QEF election”) that would allow her to avoid many of the adverse PFIC consequences, but this would require her to be taxed on the net income of the company on an annual basis, with no credit for the non-U.S. taxes paid by the company. This would cause
the daughter to be subject to annual U.S. tax even if she receives no cash distributions, and would require the company to undertake significant U.S. tax accounting work in order to provide the daughter with the requisite certification necessary to allow her to make a QEF election.

Putting the PFIC rules aside, it would be better to freeze into an unlimited liability corporation (“ULC”). The ULC is treated as disregarded entity or partnership for tax purposes. Call your U.S. tax advisor pronto.

On a side note, generally, a PFIC is a non-U.S. corporation that meets either the PFIC income or asset test. The income test is met if 75% or more of the corporation’s gross income is “passive income” (generally dividends, interests, rents, royalties and gains from the disposition of passive assets) in the taxation year. Rental income that is derived from the active conduct of a trade or business is not considered passive income for the PFIC rules (there are certain strict tests that must be met in order for the rental income to be classified as active income). The asset test is met if the average value of the assets held by the corporation during the taxable year which produce, or are held for the production of, passive income is at least 50%. When applying these rules, we can look at the income and assets of a parent and its 25% or greater owned subsidiaries on a “look through” basis to determine whether the parent is a PFIC.

**Freeze of Canadian Parent with US Resident Beneficiaries**

Mom and Dad freeze their interests in their holding company in favor of their children and it is determined that one or more of the beneficiaries of the freeze are U.S. residents. If the holding company constitutes a PFIC or a controlled foreign corporation (“CFC”) for U.S. tax purposes, the issues for the U.S. beneficiaries, whether they receive their shares directly or through a non-foreign grantor trust, will include reporting requirements (and stiff penalties for failure to comply
with reporting obligations) as well as the application of the PFIC or CFC rules. U.S. beneficiaries of a trust that owns an interest in a PFIC or a CFC will be subject to detailed reporting requirements. Under the CFC regime, U.S. residents may also be required to include their share of passive income in their U.S. tax returns as non-qualified dividends. Also, under the PFIC regime, the adverse consequences described above may apply (the U.S. tax laws provides a set of rules that govern the “overlap” between the CFC and PFIC regimes when both potentially apply). Other complications will arise and U.S. tax advice must be sought.

If the Canadian resident parents are not U.S. persons, neither citizens nor green-card holders and who do not spend enough days in the U.S. per year to be deemed U.S. tax residents, the estate freeze could be structured using a foreign grantor trust. The PFIC provisions and other tax-inefficiencies could apply if a trust is a foreign non-grantor trust for U.S. tax purposes. If, however, the trust is in fact a foreign grantor trust, the U.S. beneficiary would not be subject to U.S. income tax on the income of the trust or distributions from the trust as the foreign grantor would be deemed to be the owner of such income. A foreign grantor trust could therefore avoid adverse US tax consequences to the US beneficiaries as well as the adverse consequences resulting from the PFIC and CFC rules. The challenge in drafting these trusts is that the trust must qualify as a foreign grantor trust for U.S. tax purposes and avoid the Canadian attribution rules while still being revocable for US tax purposes. There are limited ways to accomplish this. It should also be noted that this type of trust would also avoid U.S. estate tax for US beneficiaries on the corpus of the trust in the event they passed away prior to receiving any of the assets in the trust. It should be noted that the U.S. income tax benefits of the foreign grantor trust are lost when the grantor of the trust dies, and in fact without proper planning there may be adverse consequences to the U.S. beneficiaries when they receive distributions under what is known as
the “throwback regime,” although the trust still serves an important estate tax minimization function.

Another problem, beyond the scope of this article, is if the parent implementing the freeze is a Canadian resident but also a U.S. citizen. If so, the Canadian estate freeze may give rise to U.S. gift tax.

**Wind up of a Trust with Non-Resident Beneficiaries**

You meet a new client who implemented an estate freeze 20 years ago and has now come to you because the trust is approaching its 21 year deemed disposition date and he has heard that tax would be payable if he distributes the assets to his children now living in offshore jurisdictions. One of the recommendations made to him include the distribution of all of the assets of the trust to the one resident daughter who would subsequently gift assets to the non-resident siblings. The distribution to the daughter out of the trust would be on a tax deferred basis but, of course, the gift to the siblings would trigger the realization of any capital gains on the assets. Your client, the Trustee, has no intention to benefit only one child but is stuck between a rock and a hard place. A distribution from the trust to the non-residents would trigger a realization of the gain on the assets. If those assets are shares of a Canadian company that holds passive assets and the children in question reside in the U.S. there may be further complications with ongoing US reporting and horror of all horrors, the application of the PFIC rules or CFC rules. Even if you did nothing, the U.S. residents likely already have U.S. tax problems as a result of their beneficial interest in the trust and possible PFIC or CFC status of the company.

One suggestion is to have each non-resident child assign his or her interest to a holding company (use a ULC if the non-resident child is a U.S. resident) if this is permissible under the terms of
the trust. This assignment would take place pursuant to section 85 of the Act on a tax deferred basis and an election must be filed. A section 116 certificate of compliance may be required if the interest in the trust constitutes taxable Canadian property. The Trustees of the existing trust, who have been duly notified of the assignment, would encroach on the capital and distribute that child’s share of the assets to his or her ULC. There may still be U.S. tax on accumulations in the trust if the company meets the PFIC or CFC tests. An analysis would be required on this matter to determine whether the business is an active business. If you want to get really fancy, a freeze could be implemented prior to the distribution from the existing trust and the frozen shares would be distributed to the child’s ULC. New Canadian trusts could be established for each child and his or her issue which would subscribe for the future growth in value and these trusts could be drafted such that they qualify as U.S. foreign grantor trusts. As discussed above, the tricky part is navigation of the attribution rules. The trust must qualify as a foreign grantor trust for U.S. tax purpose and yet not be subject to the Canadian attribution rules. There are numerous advantages to structuring the estate plan in this manner so that the U.S. residents’ interests are held through a foreign grantor trust.

**Subsection 55(2) of the Act and Reorganization of Share Capital**

Subsection 55(2) of the Act would have the effect of converting tax free inter-corporate dividends into capital gains subject to tax. This provision would apply on the reorganization of share capital implementing a butterfly transaction. The effects of subsection 55(2) can be avoided if there is sufficient SIOH in the corporation to protect the tax free inter-corporate dividend from the application of 55(2). If there isn’t sufficient SIOH to cover the deemed dividend on a redemption of shares in the course of a single or double winged butterfly consideration must be given to whether an exception under paragraphs 55(3)(a) or 55(3)(b)
would apply. Often times, shares are redeemed or a dividend paid without any thought as to whether this provision could apply. If it does, it could trigger a capital gain.

Where a butterfly is desired of assets, and it is determined that 55(2) may apply, it may be possible to complete a ‘dirty butterfly’ instead which involves completing the transfers of shares and assets as per the standard butterfly transaction but leaving the cross shareholding of the preference shares outstanding.

If your client has built up substantial value in his company and has more than one child, it is possible that his children do not want to hold their inheritance together. The right time to split the assets up are while the controlling parent is still alive. If, for example, your client, a mother of two adult children, has significant investments in her company and her children do not get along, a butterfly should be implemented pursuant to 55(3)(a) while she is alive and in control of the corporation. After she is gone, so is the availability of the 55(3)(a) exception if the shares are bequeathed to her kids. Siblings are deemed not to be related to each other for the purposes of this provision.

**Part VI.1 Tax Trap**

Part VI.1 tax could apply to taxable dividends paid or resulting from a redemption of shares which qualify as taxable preferred shares where the shareholder in question does not have a substantial interest in the payor corporation and certain other conditions are met. A shareholder has a substantial interest in a corporation if the corporation is a taxable Canadian corporation and the shareholder is related to the corporation or, generally, holds 25% or more of the votes and value of all of the issued shares of the corporation. Part VI.I could therefore be unexpectedly stumbled upon in transactions involving corporations with unrelated parties.
For example, the shares of the minority unrelated shareholder have been converted into fixed value preference shares whose redemption value is calculated on the basis of the fair market value of the consideration received by the corporation upon issuance of the shares. This is common practice in estate planning as often the value of the assets transferred to the corporation in exchange for the preference shares is not known at the time of transfer. Upon the redemption of the preference shares it is realized that the provisions of Part VI.I could apply to an otherwise tax free inter-corporate deemed dividend received on the shares. This provision would impose an additional tax on the payor corporation which pays a dividend in excess of the corporation’s dividend allowance for the year (generally $500,000).

When implementing a freeze under circumstances involving minority shareholders when the value of the assets to be transferred to the corporation is not known, one solution to the potential Part VI.1 tax problem is to complete the freeze using two classes of shares. One class of shares would be fixed value preference shares with a redemption value fixed at a specific amount per share ($1 per share for example). Assuming these shares meet the requirements of subsection 191(4), this provision would apply to deem the dividend to be an excluded dividend not subject to Part VI.1 tax. A smaller dollar value of shares, say 10% could be issued using a formula redemption value, allowing for an adjustment using a price adjustment clause in the event the CRA challenges the fair market value of the exchanged shares.

84.1 Tax Trap-oops No Hard Basis

Section 84.1 could apply when a taxpayer transfers shares to a corporation with which the taxpayer does not deal at arm’s length and certain other conditions apply. Two different results may occur: (a) this section could apply to reduce the paid up capital (“PUC”) of shares received
as consideration for the transferred shares to the greater of the PUC of the transferred shares or
the adjusted cost base of the transferred shares; and (b) it may apply to deem a dividend to have
been received by the taxpayer who sells his shares to a corporation if the taxpayer takes back
non-share consideration or “boot” in excess of the “adjusted cost base” of the shares sold.
“Adjusted cost base” for the purpose of this provision does not include any cost base acquired as
a result of the crystallization of the QSBC deduction in certain non-arm’s length transactions or
pre V-day value basis.

For example, your clients are two brothers who want to go their separate ways. They each hold a
50% interest in Opco. The departing brother wants to sell his shares to the other brother for cash.
The shares qualify as QSBC shares and a crystallization was undertaken years ago to step up the
cost base of the shares. The proposal is that a reorganization of Opco is undertaken to convert
each brother’s shares into a separate class. Purchasing brother would transfer his shares under
section 85 to his new holding company which would purchase the shares from the other brother.
Opco would pay a dividend up to the purchasing brother’s holdco to fund the purchase. The
brothers’ corporate lawyer has devised this plan and they now want you to comment from a tax
perspective. Of course section 84.1 would apply to deem the proceeds received by the departing
brother to be a dividend up to the amount of the QSBC deduction previously crystallized.

If there is SIOH in Opco, one solution is for departing brother to incorporate his own holding
company, transfer his Opco shares to the holding company under section 85 of the Act and have
Opco declare a dividend up to SIOH attributable to his shares. This would allow him to defer
taxation of the proceeds up to SIOH until the funds are paid out of the holding company. Of
course, tax rates on dividends are not as low as the rate on a capital gain and, depending on the
desired purchase price, there may not be enough SIOH attributable to his shares. The result is
still good as departing brother received his share of SIOH and crystallized the gain on his shares using his QSBC deduction thereby minimizing tax on capital gain in the future.

Another example of a section 84.1 trap is when the purchaser buys shares from a related family trust and the trust realizes a capital gain and allocates the gain to a beneficiary who claims the capital gains exemption in respect of QSBC shares. The purchaser then sells those shares to a wholly owned holding company for a promissory note. Section 84.1 would apply to treat the amount of note as a dividend to the extent it exceeds the adjusted cost base of the shares bearing in mind that the cost base of the shares for the purposes of section 84.1 is determined under paragraph 84.1(2)(a.1) and is ground down by the exemption claimed by the trust.

One more: Section 84.1 is often stumbled upon in the post mortem context where the estate wants to do a pipeline to extract corporate owned funds without an additional layer of tax. If the deceased claimed his QSBC deduction at death, the amount of the promissory note or the high PUC shares that can be received by the estate from the Newco tax free will be ground down by the exemption claimed.

**Post-Mortem Planning - Too Little Too Late**

Speaking of post mortems, the children of a deceased shareholder come to see you to do some post mortem planning for their father’s estate. Their father held shares in an active business with a significant insurance policy on his life. They want to know what is the best type of planning they can implement to avoid this double or triple layer of tax they heard about at their last dinner party. You tell them about the various strategies including the subsection 164(6) (the redemption of shares within the first taxation year of the estate to trigger a loss), the pipeline (the sale by the estate of the shares that were subject to the deemed disposition at death to a holding company in
exchange for a note or high PUC shares) and of course the 88(1)(d) bump (the amalgamation or wind up after death of a family holding company and operating company for the purpose of stepping up the cost base of certain “bumpable assets”). After some inquiry it is concluded that the best strategy would be a combination of the 164(6) strategy and the pipeline. Unfortunately, you find out that Dad died over a year ago and the 164(6) election to carry back the capital loss is no longer available. Given the large amount of capital dividend account from the life insurance policy, implementing the 164(6) carry back would have been effective (subject to the stop loss rules). It is however never too late to do the pipeline assuming the client’s facts fit within the parameters of the CRA guidelines concerning the application of subsection 84(2) to a pipeline.

Choosing Estate Year End

Consider subsection 164(6) when determining the fiscal period of an estate. If a short year end is chosen, it may shorten the time available for loss carry back planning which can only be executed in the first taxation year of the estate.

How not to Stumble into Section 74.4 on a Freeze

Dad wants to do a freeze and set up a family trust with his children and grandchildren as beneficiaries to hold the shares in an operating company that he hopes will sell for the big bucks one day. The trust must include minors and spouses in order to multiply the QSBC deduction and you cannot use the typical 74.4 language to carve out minors and spouses. The client is of the view that the company will always qualify as a small business corporation as he does not accumulate excess cash or investments in the company. A freeze is therefore implemented and a trust established including his wife and minor issue as beneficiaries. As the company becomes more and more successful, the need to continually purify is neglected and the shares cease to
qualify as shares of a “small business corporation”. The test the company must meet to be a small business corporation is an annual test and not just at the time of the freeze. At this point in time, section 74.4 would be applicable and Dad would have imputed income on his frozen shares unless it may be shown that income splitting was not the purpose of the establishment of the trust or unless dividends are paid.

**Freezing without a Valuation**

Your clients have agreed to undertake an estate freeze (and to pay your fees associated therewith) but they do not want to incur the expense of a valuation. They will “come up with a number” in consultation with their accountant who refuses to put his neck on the line as he is not a professional valuator. The problem is that if a reasonable attempt is not made at valuating the assets subject to a freeze, CRA may deny the use of the price adjustment clause in the event the value is in fact challenged. As a result, your clients may be viewed as having conferred a benefit to other related shareholders if the freeze in undertaken by transferring assets to a corporation with other shareholders and it is concluded that insufficient consideration was received.

**U.S. Operations of Canco**

Canadian company expands to US and forms a subsidiary for the purpose of its U.S. operations. The U.S. subsidiary is profitable and its value grows to more than 10% of the aggregate value of the Canadian company. As a result, the shares of Canco no longer qualify as shares of a qualifying small business corporation. The capital gains exemption will be lost if not previously crystallized. Furthermore, section 74.4 may now apply with respect to any trust having a spouse or minor children as beneficiaries that was set up for the purpose of multiplying the QSBC deduction on any future sale. One solution would have been to either crystallize the gain before
the shares went offside or, better yet, to structure U.S. operations in a side company instead of as a subsidiary of the Canco. If it is too late and you are already about to sell, it is possible to consider a hybrid transaction that will purify Opco immediately prior to sale by selling shares of the US company first and distributing or otherwise paying out a sufficient amount of the proceeds, assuming that the value of the U.S. operations did not exceed 50% of the aggregate value of Canco over the past 24 months.

**Wasting Freeze: Losing Control**

We always recommend a wasting freeze in situations where our clients have sufficient assets and wish to reduce the tax that would otherwise be payable on death. Redeeming frozen shares is certainly a lot smarter that paying dividends on them if you want to reduce overall tax paid. However, unless the parents have retained voting control in a separate class of shares, the annual redemption or retraction of their preference shares will eventually cause them to relinquish any control they had. It is always preferable to complete the freeze using two classes of shares for this purpose: one class of skinny voting shares and one class of full value preference shares.

**Associated Through a Trust**

Paragraph 256(1.2)(f)(ii) of the Act deems a beneficiary of a discretionary trust to own the shares that are held by that trust. Assume Dad did a freeze 15 years ago and included all of his children as beneficiaries of the trust. Son now has a business of his own and his business qualifies as an active business. Unfortunately, son’s company would be associated with Dad’s company as a result of the fact that son is included as a beneficiary of the trust. Association through a trust happens more often than you think. You may have to convert the shares held by the trust into
shares of a “specified class” or, if no distributions have been made to that child, he may be able to disclaim his interest in the trust.

Another example of this type of problem is when a minor is a beneficiary of the trust established to hold the common shares of his Dad’s operating company on a freeze. The minor’s shares are therefore deemed to be owned by his mother pursuant to the combined application of 256(2.1) and 256(1.3). As a result, Mother cannot claim the full small business deduction in respect of her own Opco as the two companies would be associated.

**Payment of CDA by Journal Entry**

Often time clients give us instruction to prepare documentation for the declaration of dividends and their designation as capital dividends. More often than not, the instructions stipulate that the dividend was paid by way of journal entry, as a reduction to the shareholder loan account.

CRA takes the position that journal entries showing a liability for payment and the reciprocal receivable for a capital dividend are not enough for the dividend to be considered “paid”. If capital dividends are being paid up the chain of companies, the net result is that the recipient of the first CDA dividend, which in turn declares a capital dividend to its shareholder, could be viewed as having made an excessive capital dividend election as it had never “received” the first capital dividend from the first corporation.

A CDA dividend can be paid and received without the transfer of funds by issuing a demand promissory note. CRA has acknowledged that a demand promissory note that is accepted as absolute payment by the recipient constitutes a capital dividend paid and received. So we use
promissory notes and assign the notes. If paying up the chain, we recommend that the dividend take place on consecutive days and not the same day.

**Capital Dividends Allocated through a Trust to a Corporate Beneficiary**

In two recent technical interpretations, the CRA confirmed that when taxable dividends are received by a trust and the trustee allocates the dividend to a beneficiary and makes the designation under subsection 104(19), the dividend is deemed to have been received by the beneficiary at the end of the trust’s taxation year in which the trust received the dividend.

Every *inter vivos* trust has a December 31 year end. If one of the beneficiaries of the trust is a corporation there could be unexpected consequences. If the corporate beneficiary’s year end is July for example, it would be deemed to have received the dividends in its taxation year ending July following the allocation and designation under subsection 104(19) by the trust. Therefore, if the dividend in question is a dividend payable out of the general rate income pool of the underlying Opco, the corporate beneficiary must wait until after its July year end to declare a GRIP dividend to its shareholders.

**QSBC Deduction and Minority Shareholder**

A minority shareholder of a company that owns less than 10.1% of Opco through his or her wholly owned Holdco doesn't qualify for the deduction in respect of QSBC shares if he sells his Holdco shares. Holdco and Opco would not be connected and therefore the shares of Holdco would not qualify. Part IV tax is also a problem under these circumstances.