Estates and Trusts Tax Update

John Loukidelis
SimpsonWigle LAW LLP
1 Hunter St E, Suite 200
PO Box 990
Hamilton, ON, L8N 3R1
loukidelisj@simpsonwigle.com
blog.simpsonwigle.com

Prepared for the Hamilton Law Association's 7th Annual Estates and Trusts Seminar, February 19, 2009

This paper addresses a miscellany of tax issues related to trusts, estates and estate-planning—problems with estate freezes, corporate beneficiaries, executor's fees and subsection 75(2)—that come up in our practices every day. The focus is on issues addressed by (relatively) recent cases or CRA technical interpretations.

Problems with Estate Freezes

The estate freeze has its own set of problem, of course, and some recent CRA technical positions and a court case have added to that set.

Thin-voting Shares

It is quite common, in effecting an estate freeze, to leave voting control in the hands of Mom and Dad by issuing "super-voting" or "thin-voting" shares to them. Each such share might be redeemable and retractable for $0.10 per share and entitled to one vote. Mom and Dad will own 1,000 such shares while the Next Generation, or a trust for its benefit, will own 100 voting Common Shares. The idea, of course, is that the super-voting shares allow Mom and Dad to continue to control Opco so that the kids can't destroy it and ruin their parents' retirement. At the same time, the redemption and retraction features of the shares are supposed to ensure that their value is nominal.

David Louis wrote an interesting article in the October 16, 2008, issue of *Tax Topics* on control premiums for such shares. The CRA, at the 2007 CTF Tax Conference, when asked about such shares responded that "It is the opinion of the CRA that a hypothetical purchaser would be willing to pay some amount for the voting control of a company." Louis also notes that at least one CRA valuator takes the position that non-voting Common Shares should be considered to have nominal value when unlimited dividends can be paid on another class of shares that has voting control. In this context, Louis refers to *Winram v. M.N.R.*, [1972] D.T.C. 6187 (F.C.T.D.).

What's a poor estate planner to do? Giving control to Mom and Dad by making them trustees of a trust that owns the voting Common Shares has its own problems, not the least of which is the conflict between the parents' fiduciary obligations to the beneficiaries of the trust and the parents' own self-interest as holders of freeze shares.

Alternatively, one could make the freeze shares voting, but query whether that might lead the CRA to attribute a value to the freeze shares that is higher than their redemption amount even though the provisions of the shares include the required redemption features and dividend cap.

In any case, what *is* the CRA up to? The estate freeze is a staple of tax planning for the owner-managed business. Why make the matter more complicated and fraught than it already is, especially given that the entire freeze concept, quite frankly, is a bit dodgy from a valuation perspective to begin with? After all, it seems likely that a hypothetical purchaser would also be willing to pay more than a nominal amount for Common Shares issued just after effecting a freeze. Why ignore that fact and then pick on thin voting shares?

The Effectiveness of Price Adjustment Clauses

Another necessary part of any estate freeze is the price adjustment clause. Valuations are an art, not a science, but the value needs to be "right". If a valuation is wrong, the tax consequences to the freezor can be dire. If the value is too low, then the freezor will have conferred a benefit on the Next Generation, and the *Income Tax Act*[1] contains a series of anti-avoidance rules that will impose something like a penalty on the freezor for making that mistake. Conversely, if the value is too high, then the corporation will have conferred a benefit on the freezor who risks having an amount equal to the excess included in his income as a result.

Desormiers c. Lalumière, 2006 QCCS 2357, seems to call into question the effectiveness of price adjustment clauses. In this case, mom had sold some shares to her son for a note. The share purchase agreement had included a price adjustment clause. The

---

[1] R.S.C. 1985, c. 1 (5th Supp.), as amended (the "Act"). All statutory references are to the Act unless otherwise noted. From time to time, I still see the Act cited by lawyers as the "*Income Tax Act*, S.C. 1970-71-72, c. 63" or as some variation of that theme. The latter statute, however, ceased to be the official version of the Act on March 1, 1994. On that date, the Governor in Council proclaimed into force the *Income Tax Act*, R.S.C. 1985, c. 1 (5th Supp.). You might think that, logically, "5th Supp." (the more general part of the citation) ought to precede "c. 1", and in fact the McGill guide recommended this at one time. Officially, however, the reverse is true, for reasons that escape me.

CRA, some time after the sale, had opined that the shares were worth much less than agreed by the parties. The price adjustment clause, then, should have reduced the principal amount of mom's note. The son, perhaps too eagerly, agreed. Mom was forced to sue her son on the note for the principal amount to which they had originally agreed. The Quebec Superior Court held—and the Quebec Court of Appeal agreed—that the price adjustment clause did not reduce the principal amount of the note that had been issued by the son. The Court found that the parties merely intended that the clause should prevent double taxation and that it should not bind the mother. In other words, according to the Quebec courts, the clause should not operate to affect the legal rights and obligations of the parties in the "real world". The Supreme Court of Canada denied leave to appeal.

If taken at face value, the result in this case is surprising and, for tax advisers, unsettling. Constantine Kyres points out that the decision, from a tax standpoint, is incoherent. A legal agreement cannot have any effect for tax purposes if it does not impose real rights and obligations on the parties. It is a fundamental principle of our tax law that the tax effect of a transaction is driven by its legal substance. Moreover, it would appear that by refusing to give effect to the price adjustment clause, some form of "double taxation" would result. Because the son and the mother were deemed to deal not at arm's length, the son would acquire the shares with a tax cost equal to the fair market value determined by the CRA. The Court's decision, in effect, means that the son will be required to pay for the shares with after-tax dollars and then pay tax on any gain that results if the shares increase in value over his deemed acquisition price for tax purposes.

What now? Do we need to re-draft our price adjustment clauses to include a clause saying "We really mean it"? It will be interesting to see what, if anything, the CRA makes of this decision, but it might be that the result was driven by the son's too-ready acceptance of the CRA's views on the value of the shares he purchased. It appears the son simply agreed to the CRA's value without doing much to test it and without consulting his mother. A standard price adjustment clause usually provides that a value is binding on the parties only if it is

> (a) an amount agreed upon by the taxing authority, the Vendor and the Purchaser to have been the fair market value of the Purchased Property on the Effective Date; or
>
> (b) in the absence of such an agreement, the amount determined by a court having jurisdiction in the matter (after all appeal rights have been exhausted or all times for appeal have expired without appeals having been taken) to have been the fair market value of the Purchased Property on the Effective Date.

One suspects that the son would have fared better in his dispute with his elderly mom if he had met the requirement in either (a) or (b) above.[2]

Classes of Shares

The Ontario *Business Corporations Act* (the "OBCA") was amended late in 2006 to provide that

> The articles [of a Corporation] may provide that two or more classes of shares or two or more series within a class of shares may have the same rights, privileges, restrictions and conditions.

Robin MacKnight, writing in the Canadian Tax Foundation's *Tax for the Owner-Manager*, pointed out that

> At the 2007 STEP National Conference, the CRA was asked how it would interpret this change in the context of the attribution and income-splitting rules. Not surprisingly, its response was that tax consequences depend on more than just a name, and it would not necessarily recognize a distinction between classes of shares on that basis alone.

Robin called the OBCA amendment "nonsensical" and criticized it in the following terms:

> [T]he courts seem clear that it is exactly those differences [in rights, privileges, restrictions and conditions] that are essential in defining and distinguishing different classes of shares for the purposes of income splitting, calculating and separating PUC and ACB, and general tax planning.

Is this fair? After all, the legislature enacts deeming rules all the time, and a deeming rule is a *fiction* created by the legislature. It is open to the legislature to call "night" "day" and "day" "night", if it suits. The Act is replete with such rules. For example, the courts had held that an amount received by a shareholder on a redemption of

---

[2] For a lengthier discussion of some of the issues surrounding price adjustment clauses, see http://blog.simpsonwigle.com/?p=201.

her shares was a capital receipt, which was not taxable as income before the Act was amended to tax capital gains. The Act, however, quite sensibly created a fiction for tax purposes so that the amount received for the shares was (and is) treated as a dividend—a "deemed dividend"—to the extent that the amount received exceeded tax paid-up capital. In light of this, it would seem to be open to the legislature to deem shares to belong to different classes even though they have identical rights, regardless of the position previously taken by the courts.[3]

In any case, my standard share provisions contain the necessary distinctions to distinguish classes of shares, and they will continue to do so, in light of the CRA's pronouncement: I have no wish to make one of my clients fight a test case on the question. But wouldn't we be better off if we could dispense with "distinctions" that, arguably, are no such thing? The distinctions in question are usually nominal. If they were anything else, they would get in the way of good planning. Our standard share provisions, when they wish to distinguish between classes of Common Shares, provide for five or ten cent differences in the entitlement of each share to the assets of the issuer on liquidation.[4] One Toronto law firm provides for differences in the periods required for notifying holders of the shares of shareholder meetings. How is this any better than the rule created by the amendment to the OBCA?

Dividends Caps on Special Shares

Sometimes we receive instructions for share provisions that include a request to create a class of shares with a fixed redemption amount and a right to receive unlimited dividends. Although nothing in the OBCA prohibits such a collection of attributes, we generally advise against creating shares that have them, especially if the shares are to be

---

[3] Moreover, one might ask whether the CRA is free to ignore the law in this manner. If it is, what else in our legal system can it ignore when it suits?

[4] These distinctions can create other problems, by the way. A Common Shares that is entitled to a five-cent preference on winding-up will be treated as a "taxable preferred share", which could subject the holder to Part IV.1 tax and the issuer to Part VI.1 tax in respect of dividends paid on the shares. The Act provides for an exemption for total dividends paid in a year that are less than $500,000 so that the taxes will not be payable. For more valuable business the exemption will not be enough, and so these taxes can present a significant problem.

used in an estate freeze. We are concerned that the fair market value of such a share will not be equal to its redemption amount, especially if the share will be held by a controlling shareholder.

In a typical freeze, Father and Mother exchange their Common Shares of Opco for Opco Special Shares with a fixed redemption amount. Any future growth in the value of Opco's issued shares is supposed to accrue to the new Common Shareholders (usually the Next Generation). It is also quite common for Father and Mother to retain voting control of Opco so that they can keep an eye on their Special Share investments.

The effectiveness of the freeze depends on the value of the Special Shares being fixed. If the Special Shares share in the growth of the value of Opco, the freeze has not served its purpose because the Next Generation will not be receiving that growth or its share of that growth will be partial. To ensure that the value is fixed, Special Shares used in a freeze will generally be redeemable and retractable for a fixed amount and entitled to non-cumulative dividends equal to a fixed percentage of the redemption amount of the shares. The share may or may not be entitled to vote. See, for example, CRA advance tax ruling ATR-36 ("Estate Freeze").

What is the position if Mom and Dad's Special Shares are entitled to unlimited dividends and Mom and Dad control Opco? In *Winram v. M.N.R.*, [1972] D.T.C. 6187 (F.C.T.D.), Gibson J. considered the liability of an estate for estate tax when the deceased husband died owning nine of the 1,000 issued shares of a corporation. The issued capital of the corporation consisted of 990 Class B shares, which were participating and non-voting and 10 Class A shares, which were participating and voting. The deceased held nine of the latter shares at his death; his wife held the remaining issued shares. It appears the estate took the position that the nine Class A shares were worth only 9/1000 of the entire value of the corporation. The Minister assessed on the basis that the value of the nine Class A shares was much greater than that. The Minister contended that, because the husband could control the issuer, he could divert dividends to himself and, in effect, take all of the value of the corporation for his own benefit. As a result, the value of his shares was significantly higher than the value ascribed to them by the estate.

The trial judge found in favour of the Minister. First, the judge noted the following about the governance of the corporation:

> Until the date of death of the deceased and at all material times prior thereto also, the Articles of Association of the company provided at Article 3 that no share might be transferred except with the consent of the Board of Directors "who (might) … in their absolute discretion refuse to register the transfer of any share"; at Article 6 that the holders of non-voting shares did not have the right to vote; at Article 17 as amended that in the case of an equality vote that the Chairman had a second or casting vote; at Article 18 that "a Director interested in any contract or arrangement under consideration may be counted to make up the quorum although he shall not vote thereon"; and at Article 20 that dividends might be declared by ordinary resolution and that "dividends so declared may be equal for each class of share or not equal and dividends may be declared on one class of share without dividends being declared on another class of share".

The judge's conclusions respecting the value of the deceased's shares is neatly summarized in the headnote:

> The wife of the deceased could not, by wilfully refusing to attend a properly called directors' meeting, prevent the deceased from transferring the nine class A shares of which he was the owner, or from declaring dividends whereby the company would pay out 90% of the surplus to himself. Even if she did attend such a meeting, the deceased, because of his casting vote, could take these steps. Such action would not have been an abuse of his power in respect of the class B shareholders as they did not have an inalienable right to any part of the dividends declared, nor would it have been a breach of the deceased's fiduciary duty as a director for he would have also been acting in his capacity as a shareholder and would therefore be free of any constructive trust. Also, any dividends declared on class A voting shares at a properly called directors' meeting would not have been an abuse by the majority of the class A holders over the rights of the minority of class A holders.

Winram dealt with two classes of shares, both of which were fully participating. Perhaps the court would have arrived at a different conclusion if the shares had been redeemable and retractable for a fixed amount. Moreover, the decision has been distinguished in another case involving similar circumstances (see *Shepp v. The Queen*, [1999] D.T.C. 510 (T.C.C.)).

But why wonder about the status of *Winram*? It would seem prudent simply to ensure that the freeze shares have a dividend cap. If the freezor wishes to continue to share in the value of the corporation going forward, it would be better to put an estate "gel" in place or leave the freezor with some portion of the Common Shares.

Corporate Beneficiaries

It is often quite useful to have Holdco own shares of Opco through a trust rather than directly. In general, the other beneficiaries of the trust can still claim the capital gain exemption in respect of a disposition of the shares of Opco,[5] and keeping the redundant assets of Opco to a minimum while deferring tax at the individual shareholder level can be as simple as paying a dividend from Opco that is allocated to Holdco as a beneficiary of the trust.[6] The latter is an important goal because redundant assets could prevent the Opco shareholders from claiming the capital gain deduction.

In fact, these goals—claiming the exemption for as many individuals as possible, deferring tax at the shareholder level and removing assets from Opco to keep it "pure" for the purposes of the exemption—often interfere with one another. On the one hand, only an individual can claim the capital gain exemption, and so it is generally desirable to ensure that, to the greatest extent possible, individuals own the Common Shares of Opco (the growth shares). On the other hand, to make sure that the Opco shares qualify for the exemption, it is often necessary to remove redundant assets from the corporation, and the

---

[5] A trust is not a true flow-through entity for tax purposes. For examples, the losses of a trust cannot be allocated to its beneficiaries. The Act, however, contains provisions that allow a trust to make designations in respect of its distributions to beneficiaries so that the trust's capital gains and dividends retain their character as such in the hands of the beneficiaries. The CRA accepts that a designation of a gain realized on a disposition of a qualified small business corporation share permits the beneficiary who receives the distribution so designated to claim the capital gain deduction to offset the gain. This is how a trust can be used to "multiply" the capital gain exemption.

[6] For an application of the rules relating to redundant assets, see *Estate of Edward Reilly v. The Queen*, 2007 TCC 404, which considers whether shares of a corporation owned by an individual were qualified small business corporation shares (QSBCS) at the time of his death. If the shares had been QSBCS, the individual's estate would have been entitled to claim the capital gains exemption to eliminate the gain the individual realized on death in respect of the shares. The Court concluded that the shares were not QSBCS because a subsidiary of the corporate issuer held too many redundant assets:

> There is no evidence that the cash and marketable securities held by [the subsidiary] were necessary or even important for the carrying on of its small active businesses. Or in the words of [*Ensite Limited v. The Queen*, [1986] 2 S.C.R. 509, 1986 CanLII 41], there is no evidence that the cash and marketable securities were held "to fulfill a mandatory condition precedent to trade".

The decision is unsatisfying because it seems to use "book value" and "fair market value" interchangeably. Only the latter is relevant to the QSBCS test. In addition, the Court gave no consideration to off-balance sheet items like goodwill, probably because the taxpayer provided no evidence about its value. The amount in issue was not large, but it might have been worth it to present at least some evidence about goodwill.

easiest[7] and most tax-effective way to do this is to pay dividends on Common Shares owned by Holdco (business earnings paid as dividends generally pass tax-free between corporations). But every share held by Holdco is a share for which the exemption cannot be claimed.[8] A trust that holds Common Shares of Opco where Holdco is a beneficiary of the trust reconciles all of these tensions.

Of course, making a corporation a beneficiary of a trust has its own set of issues, and some of the most important aren't tax related. I'll let others address the non-tax issues. Perhaps the most important tax issue is Part IV tax. If Holdco is subject to Part IV tax on dividends it receives from Opco because the former is a beneficiary of a trust, then not much has been accomplished as far as deferring tax at the individual shareholder level is concerned. No deferral is available because of the imposition of the refundable tax, and the individuals involved would have been better off simply paying dividends to themselves to reduce the value of redundant assets.

To avoid Part IV tax, Holdco, as a beneficiary of the trust, must be connected with Opco, and Holdco will be connected only if it satisfies either the 10% votes-and-value test or it controls Opco. To satisfy the 10% votes-and-value test, Holdco must own shares of Opco. The CRA, however, takes the position that the beneficiary of a trust does not own the trust's property. Holdco, then, if it "holds" shares of Opco only as a beneficiary of a trust, can never satisfy the 10% votes-and-value test. For example, assume that Steve is the owner of all of the shares of Holdco, which is the beneficiary of a trust that owns 30% of the issued Common Shares in the capital of Opco. The remaining 70% of the Common Shares in the capital of Opco are held by an individual with whom Steve deals at arm's length. In these circumstances, Holdco will not be connected with Opco under the 10% votes-and-value test because Holdco does not own any Opco shares.

---

[7] There are other ways to purify Opco, of course. For example, Opco might undertake a single-wing butterfly to "pay" retained earnings to a sister corporation. Such a reorganization is relatively expensive and difficult to undertake however. Moreover, it cannot be completed on a tax-deferred basis if a sale to an arm's-length third-party is contemplated.

[8] If Holdco exists to hold redundant assets, it will not be long before its shares cease to qualify for the exemption even if a significant portion of the value of the Holdco shares is attributable to the Opco shares.

Holdco will be connected with Opco, then, only if Holdco controls Opco under subsection 186(2) of the Act. Holdco will control Opco only if persons not dealing at arm's length with Holdco own more than 50% of the shares of Opco having full voting rights in all circumstances. Holdco is deemed not to deal at arm's length with the trust of which it is a beneficiary (paragraph 251(1)(b) of the Act). Subsection 186(2) states that, for the purposes of its definition of control, Holdco will be deemed to own all of the shares held by a person with whom Holdco does not deal at arm's length. Of course, in our example above, Holdco will be deemed to own only 30% of the issued Common Shares in the capital of Opco, which is unhelpful from the standpoint of Part IV tax. The position would be different if the trust held 70% of the issued Common Shares in the capital of Opco. In that case, Holdco would be deemed to own the shares, and so it would be deemed to control Opco. Holdco, then, would be connected with Opco, and the CRA accepts that any dividends paid by Opco to the trust that are then allocated to Holdco would be free of Part IV tax (assuming that Opco did not receive a refund of tax in respect of the dividends declared).

What happens if two brothers, A and B, each own all of the shares of their respecting holding corporations (HoldcoA and HoldcoB), which in turn are beneficiaries of trusts (TrustA and TrustB) that own 50% each of Opco? Neither TrustA nor TrustB controls Opco by itself for the purposes of Part IV: neither owns more than 50% of the voting shares of Opco. The Holdcos, however, will be related to each other (per paragraph 251(6)(a), subparagraph 251(2)(c)(ii) and paragraph 251(1)(a) of the Act). In addition, paragraph 251(1)(b) of the Act provides that

> a taxpayer and a personal trust (other than a trust described in any of paragraphs (a) to (e.1) of the definition "trust" in subsection 108(1)) are deemed not to deal with each other at arm's length if the taxpayer, *or any person not dealing at arm's length with the taxpayer*, would be beneficially interested in the trust. [Emphasis added]

In the example above, HoldcoA and HoldcoB are deemed not to deal at arm length with each other. As a result, HoldcoA is deemed not to deal at arm's length with TrustA *and* TrustB. HoldcoA is deemed not to deal at arm's length with TrustB because HoldcoA and HoldcoB are related and HoldcoB is beneficially interested TrustB. HoldcoA, then, is deemed to control Opco under 186(2), and any dividends paid from

Opco through TrustA to HoldcoA should not be subject to Part IV tax (assuming that Opco doesn't have RDTOH).[9]

Executor's Fees

For quite some time now, the CRA has taken the position that (to quote the *Employers' Guide - Payroll Deductions and Remittances*):

> Fees paid to executors or liquidators and administrators are either income from office or employment or business income, depending on whether the executor or administrator acts in this capacity in the regular course of business.

IT-377R (archived) discusses the distinction in more detail:

> 5. A fee earned for the administration of an estate by an executor thereof will be treated either as income from a business or income from an office, depending on the particular circumstances of each case. Fees earned by a taxpayer for acting in the capacity of executor in the course of business form part of the business income of the taxpayer, and expenses incurred in this connection are deductible in the usual way in computing such income, to the extent they are not recoverable from the funds of the estate. Where the executor is a person who does not act in this capacity in the course of carrying on a business, the fee for acting as executor is considered to be income from an office. (Such a situation could exist even where the executor is a lawyer if the normal practice does not include executorships and the lawyer was appointed on personal grounds, perhaps because he or she was a friend or relative of the deceased.)[10]

My practice does not usually include acting as an executor of estates, but I do act as the executor of my father's estate. If I were to earn fees for acting as the executor of my father's estate, I would be considered to earn income from an office for tax purposes, according to the CRA.

---

[9] What to do if A and B deal with each other at arm's length? A might consider incorporating Holdco1 to hold his 50% of the Common Shares in the capital of Opco. A trust would hold the Common Shares of Holdco1. A would own all of the Common Shares in the capital of Holdco2, which would be a beneficiary of the trust. Dividends paid from Opco to Holdco1 would not be subject to Part IV tax because Holdco1 would meet the 10% votes-and-value test. At the same time, dividends paid from Holdco1 to the trust and then to Holdco2 would also be exempt from Part IV tax because of the analysis set out above where the trust controls Opco. Whether Mr. A will wish to deal with so many corporations will depend on the value of the exemptions that might be available to the beneficiaries of the trust and the tax that can be deferred by removing redundant assets from Opco to Holdco2.

[10] For a relatively recent technical interpretation that restates this position, see CRA technical interpretation 2007-0250501E5 dated May 27, 2008.

Sometimes this distinction can be quite important. The deductions available under the Act to an employee or officer are more limited than those available to someone carrying on a business. Moreover, an estate that pays fees to an executor who is an "officer" is required by the Act to withhold and remit source deductions in respect of the fees. Subsection 153(1) provides that

> every person paying at any time in a taxation year [...] salary, wages or other remuneration [...] shall deduct or withhold from the payment the amount determined in accordance with prescribed rules and shall, at the prescribed time, remit that amount to the Receiver General on account of the payee's tax for the year

"Salary, wages or other remuneration" are defined as "the income of a taxpayer from an office or employment [...] and includes all fees received for services not rendered in the course of the taxpayer's business".

The *Income Tax Regulations* contain detailed rules on the amounts to be withheld from remuneration and the timing of the withholding. The Regulations will prescribe when and what amounts must be withheld from an executor's compensation. An estate paying such compensation is required to obtain a payroll account number to effect the withholding. The CRA withholding guide also makes it clear that executor's compensation, where the executor is an employee, is subject to CPP and, in certain cases, EI withholding.

The detailed rules in the Act and the Regulations governing source deductions are beyond the scope of this article. In any case, each case must be reviewed carefully in light of the requirements of these rules to determine what must be withheld and when. Any executor, or any person advising an executor, would do well to consult these rules and the CRA publications that attempt to explain them before paying compensation to an executor. Failing to withhold can leave the estate and its executors liable for interest, penalties and, in certain circumstances, the amount that was not withheld.

So, an executor who receives fees for acting as such must include the fees in income, usually as income from an office (employment income). Can this result be avoided if the fees are called a "legacy" in the will that provides for their payment? Not according to *Messier v. The Queen*, 2008 TCC 349.The taxpayer's uncle died leaving numerous legacies to various nieces and nephews. The taxpayer was appointed a

"liquidator" under the will, for which the taxpayer was entitled to receive a "legacy" (ie a gift, so-called) "for fulfilling the duties of his office". The notary who prepared the will also testified that if the taxpayer had not performed the duties of his office, he would not have been entitled to the "legacy".

In light of this evidence, the Tax Court had little trouble concluding that the "legacy" was really a fee for performing the office of an executor or liquidator and that the CRA had been correct to reassess the taxpayer to require him to include the amount in income for tax purposes. The Court reached this conclusion despite the fact that the CRA had agreed that an identical "legacy" provided through the will of another of the taxpayer's relatives was not taxable.[11]

Loans and Subsection 75(2)

In an article that I wrote for the Hamilton Law Association *Journal*, I discussed the *Howson* case (2006 TCC 644). The Howsons wished to immigrate to Canada from South Africa. As part of the move, they established the Howson Family Trust. Mr. and Mrs. Howson were beneficiaries of the trust. In June, 1994, the Howsons advanced funds to the trust. In June, 1997, the trust executed a loan agreement in respect of the advance, which agreement purported to be pursuant to an oral agreement effective as of the date of the advance. The agreement allowed, but did not require, the lender to charge interest. The lender was also entitled to demand repayment on three-months' notice. The agreement also required the trust to repay all capital and interest owing on the loan within 10 years from the date of the advance.

The CRA tried to argue that the Howsons had contributed funds to the trust and that the funds were held on condition that they could revert to the Howsons. The Court disagreed.

> It stands to reason that a bona fide loan is, on its face, not subject to reversion by the terms of the Trust. It returns to the lender by operation of the loan itself and the law of creditor rights. The Respondent did suggest that there may be

[11] The Court referred to *Klassen v. The Queen*, 2007 FCA 339, for the proposition that "The Minister is not bound by a previous decision of one of its officials, if that decision was erroneous."

> circumstances where an arrangement that may look like a loan could be caught by this condition of reversion. The Respondent did stress, however, that this was not one of those cases. This was simply a case of there not being a loan, but that the 748,000 Rand on balance represented a contribution to the corpus or capital of the Trust. With respect, I disagree.

The Court held that the parties intended, and created, a valid loan in 1994 so that subsection 75(2) did not apply to the trust. The Howsons testified that they always intended that the funds would be repaid. The agreement was signed after the fact, but there was no evidence to suggest that it was anything other than what it purported to be: a document that set out on paper the pre-existing agreement between the parties. Moreover, financial statements for the trust in 1996, 1997 and 1998 reflected the amount advanced as a loan. The Court even held that the use of sophisticated tax advisers made it extremely unlikely that the parties would be mistaken about such a simple point (the nature of the advance). The Crown also argued that the fact the arrangement did not provide for interest or security suggested no bona fide loan existed. The Court disagreed. The Court pointed out that legally a lender need not charge interest or require security. The Court also noted that it would have been silly for the lenders to require security when the borrower was a trust for the benefit of the lenders and their children.

It appears that the CRA accepts this decision. In CRA technical interpretation 2008-0268121E5 dated June 23, 2008, the CRA considered the position of a trust where one of its beneficiaries made a non-interest bearing loan to the trust, which used the funds to acquire shares of a corporation. The CRA accepted that the loan did not necessarily constitute a “contribution” for the purposes of the 75(2) simply because one of the trust’s beneficiaries made the loan and it was interest-free.

On the other hand, the CRA stated that 75(2) might apply if the trust used the loan proceeds to buy shares from a capital beneficiary of the trust. Presumably the CRA is concerned that the shares could revert to the beneficiary pursuant to the terms of the trust, which would trigger the application of subsection 75(2).

Conclusion

The CRA and the courts seem to be adopting some positions that are making the lives of professional advisers more difficult when it comes to estate freezes. On the other

hand, it would appear that it has accepted a court decision on subsection 75(2) that permits more flexibility, and on the question of executor's fees, the CRA continues to maintain a long-standing position.