

S T E P

Society of Trust and Estate Practitioners

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Delivered via e-mail and regular mail

**TAX LEGISLATION DIVISION
DEPARTMENT OF FINANCE**
140 O'Connor Street
Ottawa, ON K1A 0G5

Attention: Len Farber, General Director

Dear Sir:

Re: Society of Trust and Estate Practitioners Comments and Submissions Regarding September 16, 2004 Legislative Proposals ("Draft Legislation") – Subsection 40(3.6) of *The Income Tax Act* (the "Act")

Thank you for the opportunity to respond to the September 16, 2004 Draft Legislation and specifically the impact that such proposals will have on subsection 40(3.6) of the Act.

A. INTRODUCTION

The Society of Trust and Estate Practitioners ("STEP") is the professional body for trust and estate professionals worldwide. The Society was formed in 1991 and now has over 10,000 members. In Canada alone, there are over 2,000 STEP members from the legal, accountancy, corporate trust, banking, insurance and related professions. To gain membership, professionals must demonstrate involvement at a senior level in the planning, creation, management of and accounting for trusts and estates, executorship administration, and related taxes. Members of STEP include the most experienced and senior practitioners in the fields of trust, estates and taxation. STEP's mission statement is "*to be recognized and accepted as the principal professional body for trust and estate practitioners worldwide.*" A number of years ago, the STEP Technical Committee was organized to comment and provide submissions on legislative proposals that impact, either directly or indirectly, upon trusts and their beneficiaries, estate planning and related tax matters.

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At both the June, 2003 STEP National Conference (Toronto) and the February, 2004 Department of Finance Round Table (Calgary STEP Branch), concerns were raised about the interplay and possible conflict of the stop-loss rule in subsection 40(3.6) and the relieving rules found in subsection 164(6). Since a private corporation can often be affiliated personally to the estate when a shareholder dies and a share redemption constitutes a disposition to the company, any capital loss realized by the estate could be denied under subsection 40(3.6) of the Act. If the estate holds no shares at the end of the series of transactions, there is no adjusted cost base that could be adjusted, possibly resulting in a loss being denied entirely. Accordingly, at the 2003 STEP National Conference, the Technical Committee suggested to the Department of Finance that the stop-loss rules should not work this way. At the 2003 STEP National Conference and the February 2004 Calgary Round Table, the Department of Finance appeared to be sympathetic to the issue at hand and suggested that such issues were currently under review.

The September 16, 2004 Draft Legislation appears to be a partial response to some of the issues and concerns that STEP has raised. Notwithstanding, as we will note in this submission, STEP believes that such proposals do not go far enough and, unfortunately, will cause further unexpected problems should such proposals be enacted as proposed.

B. COMMENTS

Prior to the 2004 Federal Budget proposals, the definition of “affiliated persons” applied in limited circumstances with trusts.¹ Now, the Draft Legislation that proposes to implement the 2004 Federal Budget proposals expands and alters the concept of a trust being affiliated with a person.² These proposals are effective after March 22, 2004 with no grandfathering provisions.

New proposed subparagraph 251.1(4)(c)(iii) introduces a relieving provision into the Act wherein a reference to a trust does not include a reference to the trustee or other persons who own or control a trust property. This provision is welcome and useful in situations where an estate could otherwise have been affiliated to another person to the extent that the reference was to the trustee. STEP welcomes the addition of such provision into the Act in this context.

STEP has a significant concern about the proposed new trust affiliation rules. The concern can best be explained by way of an example. Consider the following example facts³:

1. Mr. Roberts is Canadian resident individual.
2. Mr. Roberts is married to Sandra who is also a Canadian resident. Mr. and Mrs. Roberts have two children – John (aged 23) and Janice (aged 30). John and Janice are also Canadian residents.

¹ For example, a trust that controls a corporation could be affiliated with a corporation pursuant to subparagraph 251.1(1)(b)(i).

² See proposed paragraph 251.1(1)(g) and (h) which sets out when a trust would be affiliated with a person and where two trusts would be affiliated respectively.

³ Such example is reproduced with the permission of Kevin Wark, LLB, CLU, CFP, TEP of PPI Financial. Such example is in his paper which is being presented at the Ontario Tax Conference of the Canadian Tax Foundation on October 19, 2004.

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3. Mr. Roberts is the controlling shareholder of “Robco” – a Canadian controlled private corporation.⁴
4. The fair market value of all the issued shares of Robco is \$4 million.
5. Janice is active in the business of Robco. As a result, Mr. Roberts has made plans that would have Janice eventually take over Robco as the controlling and active shareholder.
6. In order to carry out the succession plan of Mr. Roberts, Mr. Roberts completed an “estate freeze” whereby his common shares of Robco were exchanged for a class of voting preference shares (the “Pref A shares”) that has an adjusted cost base (“ACB”) and paid-up capital (“PUC”) of \$1 and a redemption value of \$4,000,000
7. As part of the estate freeze, Janice was issued new common shares of Robco with a nominal value.
8. Mr. Roberts has entered into a buy-sell arrangement with Janice. Such agreement provides that on Mr. Roberts’ death, the Pref A shares are to be redeemed by the corporation.
9. Mr. Roberts’ will provides for his lawyer and close friend, Larry, to be the executor. Under Mr. Roberts’ will, the remainder of Mr. Roberts’ estate will be held in a trust under which Sandra, John and Janice are both discretionary income and capital beneficiaries. The trust also has provision for any grandchildren of John and Janice as discretionary capital beneficiaries.
10. Shortly after implementing the above planning, Mr. Roberts dies.
11. Once Mr. Roberts passes away and the terms of Mr. Roberts’ will and the buy-sell agreement are carried out, Janice will be affiliated with Robco after the redemption of the Pref A shares held by the estate as she will be the controlling shareholder.⁵ Janice will also be affiliated with the trust established under Mr. Roberts’ will as she will be a “majority interest beneficiary”.⁶ To the extent that a person is a majority interest beneficiary of a trust, such person and the trust will be affiliated.⁷ Accordingly, after the Pref A shares are redeemed by Robco, the estate would be affiliated with Robco because Janice is affiliated with both the estate and Robco.
12. Accordingly, the loss realized by the estate on the redemption of the Pref A shares that would otherwise be carried back to the terminal return of Mr. Roberts pursuant to subsection 164(6) would be denied by subsection 40(3.6) since the corporation and the estate would be affiliated. In our example, this would result in a \$4.0 million loss denial.
13. The result of such loss denial is that Mr. Roberts’ estate, subject to possible other potential planning, would pay tax on a deemed disposition of his Pref A shares of Robco and the estate would pay tax on

⁴ As that phrase is defined under subsection 125(7) of the Act.

⁵ See paragraph 251.1(1)(b).

⁶ See the proposed definition of a majority interest beneficiary under proposed subsection 251.1(3).

⁷ See proposed sub-paragraph 251.1(1)(g)(i).

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the resulting deemed dividend on the redemption of the Pref A shares. Accordingly, in the absence of further planning, double taxation would result.

C. CONCLUDING COMMENTS AND POSSIBLE SOLUTION

STEP believes that the above example clearly highlights the problem that the Draft Legislation will cause to the extent that such legislation is enacted as proposed. STEP is not aware of any tax policy change in this area and therefore believes that such result must be unintended. If correct, STEP would ask that the Department of Finance consider drafting provisions into the trust affiliation proposals that would carve out corporation share re-purchases held by a deceased individual shareholder's estate from the impact of subsection 40(3.6).

The STEP Technical Committee would be pleased to provide further detail if need be or to meet with your representatives to discuss our concerns in greater detail.

We trust the above is satisfactory but should you have any questions or comments please call.

Yours very truly,



Kim G C Moody, CA, TEP
Chair, STEP Canada Technical Committee/
Deputy Chair STEP Canada



Paul R. LeBreux, LL.B., LL.M., TEP
Deputy Chair, STEP Canada, Past Chair,
STEP Technical Committee

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cc. Branch Chairs, STEP Canada
Branch Technical Chairs