INCOME TAX ATTRIBUTION RULES

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The federal Income Tax Act (the "**ITA**") includes a series of rules that can attribute income earned by one taxpayer to another taxpayer. These are commonly referred to as the attribution rules.[1] Most of the attribution rules are located in sections 74.1 to 75 of the ITA. In keeping with the Canadian income tax custom of never having all the rules together in a single place, however, other attribution rules are secreted away in section 56(4.1). An attribution rule relating to the principal residence exemption lurks in section 54.

Why Have Attribution Rules?

These attribution rules stem from two fundamental aspects of the Canadian income tax system.

1. Canada imposes income tax on each separate person rather than on groups of persons. Specifically, each member of a family files a separate income tax return rather than aggregating all family income in a joint family return.

2. Individuals pay income tax at graduated rates rather than at flat rates. As taxable income increases, so does the marginal rate of income tax.

As a result, less overall tax is paid if each spouse reports $50,000 in taxable income (as opposed to one spouse reporting $100,000 of income). This creates an incentive for a high income earner to divert income to a lower-income family member.

The income tax attribution rules seek to prevent a high-rate taxpayer from diverting income to a lower-rate taxpayer.

Statutory Structure of Attribution Rules

The attribution rules are contained in the following provisions of the ITA.

1. Section 74.1 deals with attribution of income (spouses and tax minors).

2. Section 74.2 deals with attribution of capital gains (spouses only).

3. Section 74.3 deals with calculating attribution amounts when the income and capital gains are realized through a trust.

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4. Section 74.4 deals with the so-called corporate attribution rules.

5. Section 74.5 provides exceptions for fair market value transfers and loans, sets out deeming rules in respect of back-to-back loans and transfers and in respect of guarantees, and deals with miscellaneous other rules.

6. Section 75 deals with attribution rules for reversionary trusts. These rules will be dealt with in one of the other papers at this conference.

7. Section 56(4.1) deals with attribution in respect of loans to non-arm's length individuals who are 18 or over (but not spouses).

GENERAL PRINCIPLES

Before getting into details of the attribution rules, some general comments will be useful. In order to illustrate these general comments, I will assume that husband (Husband) is the sole income earner of the family and lends or gifts $1,000 to his wife (Wife). Wife has no income of her own. Of course, attribution can work the other way if the wife is the higher income-earner.

Whenever this article refers to a spouse or a spouse-like term such as husband or wife, the reference includes a common-law partner, common-law husband or common-law wife.

1. In general, attribution rules work by attributing the income earned by one person to another person. If Husband gifts $1,000 to Wife and Wife uses that gift to buy shares of XYZ Corporation, any dividends or capital gains realized by Wife on the shares of XYZ Corporation will be taxed as if the dividends or capital gain had been realized by Husband. In other words, Husband has to report the dividends and capital gains as his dividends and capital gains. This means that the income and capital gains is taxed at Husband's tax rate.

2. Attribution rules apply only for income tax purposes. The federal government has no jurisdiction over property and civil rights (these are provincial responsibilities under the Canadian constitution). If income of Wife is attributed to Husband for income tax purposes, that affects only the amount of income tax paid on that income and the identity of the person who is obligated to pay that tax. Under provincial law, Wife is still the owner of the income and gets to keep the income (without deduction of any tax).

3. Attribution applies on a tracing basis. If a gift is transformed into another type of property, attribution continues to apply through any number of transformations. However, attribution does not apply to any new property that is generated by the loan or gift.

4. Assume that Husband gifts $1,000 to Wife and Wife uses the $1,000 to buy 10 shares of XYZ corporation. Wife has transformed the $1,000 into shares of XYZ corporation, so the shares have been substituted for the $1,000 and attribution will apply in respect of any income or capital gains realized by Wife on those shares.

5. Assume now that Wife sells the XYZ shares for $1,400, realizing a $400 capital gain.

Husband will pay the tax on that $400 capital gain, so Wife will have the whole $1,400 to reinvest. Assume that Wife reinvests the $1,400 in shares of ABC corporation.

6. The shares of ABC corporation will have been substituted for the shares of XYZ corporation, which were themselves substituted for the original $1,000 gift. So any dividends or capital gains realized by Wife in respect of the ABC shares will be attributed back to Husband.

7. The ABC shares are substituted property even though the original gift was only $1,000 and the ABC shares cost $1,400. This is because the $1,000 was used to buy the XYZ shares and the XYZ shares grew in value. In classical capital property parlance, the $1,000 represents a seed that becomes a tree. As the $1,000 is substituted for the XYZ shares and then the ABC shares, the original seed has grown but all that growth is the original seed in a transformed state.

8. Contrast the substituted property treatment with the treatment of new property. Assume that Wife earned $150 in dividends on her shares of XYZ corporation. Of course, Husband will pay tax on that $150 and this will leave Wife with $150 to reinvest. However, that $150 is new property and not substituted property. The $150 is akin to the fruit on the tree – new property and not part of the original tree.

9. If Wife invests the $150 in a guaranteed investment certificate, the interest earned by Wife will be taxed as income of Wife and will not be attributed to Husband.

10. This is because the dividend is not substituted property for the original $1,000 gift. It is new property – the fruit of the tree.

11. Of course, there is a qualification to the above rule about income. At law, a stock dividend declared on a share is income (the creation of new property) rather than the substitution of one property for another. Notwithstanding this, the ITA deems that shares issued on a stock dividend are considered to have been substituted for the shares on which the stock dividend was declared.[2]

12. Returning to the above example, assume that XYZ corporation pays a stock dividend to Wife. The amount of the stock dividend is $100 and consists of special shares on which XYZ corporation pays dividends of $500.

13. Husband will pay tax on the $100 stock dividend because the dividend is paid on the XYZ shares (substituted property for the original $1,000 gift).

14. Husband will also pay tax on the $500 dividend paid on the stock dividend shares because those shares are deemed to be substituted property.

15. In general, the attribution rules apply only to passive investment income. Attribution does not apply to business income.

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[2] ITA section 248(5).

16. Let us return to that original $1,000 gift from Husband to Wife.

17. If Wife uses that $1,000 to buy shares of XYZ corporation, any dividends received by Wife will be taxed as income of Husband.

18. In contrast, assume that Wife uses the $1,000 gift as seed capital to start an active home-based internet retail business (her own sole proprietorship). In that case, any business income earned by Wife will be taxed as Wife's income and attribution will not apply.

19. If Wife uses the $1,000 gift to buy a unit in a limited partnership, however, attribution will apply.

20. While partnership income is usually considered business income, a specific provision in the ITA deems income of a limited partner to be income from property for purposes of the attribution rules.[3]

21. This deeming rule will also apply if Wife is a general partner but is not actively engaged in the business activities of the partnership on a regular, continuous and substantial basis. Wife will not be considered to be engaged in business activities of the partnership if Wife is involved solely in financing activities of the partnership.

22. Attribution applies in respect of gifts and interest-free or low-interest loans.

23. A low-interest loan means a loan in respect of which the interest rate is less than the prescribed interest rate in effect at the time that the loan is made.

24. Given that the prescribed interest rate is currently only 1%, some opportunity exists for locking-in that low interest rate and putting a structure in place for splitting income once interest rates start to rise.

25. Attribution does not apply on "saved" amounts (even if the high-income earner makes it possible for the low-income earner to do the saving). For example, assume that Husband pays all the household expenses. This allows Wife to save and invest all her own independent earnings. In this situation, there has been no transfer or loan from Husband to Wife and no attribution applies on any of Wife's investment earnings.

26. Attribution applies in respect of income and capital gains as between spouses. In respect of minor children, however, attribution applies only in respect of income (not capital gains). An attribution rule also applies in respect of interest-free or low-interest loans to non-arm's length adults.

27. Gifts and loans can be made on an indirect basis through a trust or other vehicle. Attribution still applies even if the gift or loan is made indirectly.

28. Attribution will apply while the transferor/lender is a resident of Canada. No attribution

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[3] ITA section 96(1.8), read together with the definition of "specified member" in ITA section 248(1).

applies while the transferor/lender is not a resident of Canada.

29. Subject to a very big exception (the so-called corporate attribution rules), attribution applies only to the extent that income is produced by the loaned or transferred property. However, the corporate attribution rules can result in the creation and taxation of deemed income that does not exist in reality. The corporate attribution rule can apply in various circumstances, including a conventional estate freeze.

30. In general, attribution applies in respect of income and losses. If the attempt is to split income, of course, one hopes for income rather than losses. If the transferred or loaned property ends up generating losses, however, the loss will also be attributed to the transferor/lender. This general statement, however, has to be qualified by the decision of the Supreme Court of Canada in *Lipson*. The *Lipson* decision has been criticized by numerous commentators and can perhaps best be explained as a reminder that danger lurks if one is "too cute".

TRANSFERS AND LOANS TO SPOUSES: ATTRIBUTION OF INCOME AND CAPITAL GAINS

The rules in respect of spouses (including common-law partners) are set out in ITA section 74.1(1) (for attribution of income) and in ITA section 74.2(1) (for attribution of capital gains).

As noted in the general summary, the rules are triggered by a direct or indirect transfer or loan. The transfer or loan can be made to or for the benefit of the spouse or to a trust for the benefit of the spouse.

If the transfer or loan is to the spouse directly, the attributed income and capital gain is the income and capital realized by the spouse on the transferred or loaned property. If the transfer or loan is to a trust for the benefit of the spouse, attribution will apply only to the extent that the trust allocates income or capital gain to the spouse.[4] If the income or capital gain is taxed inside the trust, the income or capital gain will be subject to the top marginal rate in any event because an *inter vivos* trust pays the top marginal rate of tax on income or capital gains that is taxed inside the trust.

As noted in a leading case on the matter, "transfer" is a non-technical term of broad application.[5]

> The word "transfer" is not a term of art and has not a technical meaning. It is not necessary to a transfer of property from a husband to his wife that it should be made in any particular form or that it should be made directly. All that is required is that the husband should so deal with the property as to divest himself of it

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4 ITA section 74.3. Technically, attribution applies to the lesser of the income or capital gain allocation to the spouse and a pro-rata portion of the income or capital gain that is allocated to all designated persons in respect of the transferor (other designated persons could include minor children of the transferor).

5 *Fasken Estate* v *MNR*, [1948] CTC 265 (Exch), at p. 279, per Thorson P.

> and vest it in his wife, that is to say, pass the property from himself to her. The means by which he accomplishes this result, whether direct or circuitous, may properly be called a transfer.

A transfer can include a sale or a gift.

An indirect transfer can include a transfer made between successive intervening entities. The CRA also characterizes the following as an indirect transfer.[6]

> Assume that a husband owns 90% of the shares of a corporation and the wife owns 10%. An indirect transfer will occur if the corporation issues additional shares to the wife for consideration that is less than the fair market value of the additional shares and the issuance of the additional shares changes the proportionate shareholding as between the husband and the wife.

If the transfer or loan was made before the recipient became a spouse of the transferor/lender, the attribution rule will apply as of the time that the recipient becomes a spouse.

As noted, no attribution applies while the transferor/lender is not a resident of Canada. Based on the wording in the statutory provision, it seems that transfers and interest-free and low-interest loans made before the transferor/lender became a resident of Canada can trigger attribution as of the time that the transferor/lender becomes a resident of Canada. However, two cases have come to opposite conclusions on this point (based on previous versions of the rules).[7]

Fair Market Value Loans Between Spouses

As noted, a low-interest loan means a loan in respect of which the interest rate is less than the prescribed interest rate in effect at the time that the loan is made.[8] The prescribed interest rate is currently only 1%, so this gives some scope for setting up advantageous loan arrangements.

Husband could lend $100,000 to Wife for a 20-year term at a simple interest rate of 1%. Assuming that Wife does not make any principal repayments, Wife would have to pay interest of $1,000 per year to Husband and Husband would pay tax on that annual interest amount. However, Wife would pay tax on any income in excess of $1,000 and the income-splitting objective would have been achieved to the extent that Wife earns a return that is greater than 1%. Even if Wife invests in a bond or some other fairly conservative investment, this should be achievable.

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[6] See paragraph 1 of Interpretation Bulletin 511R (issued on February 21, 1994).

[7] Contrast the decision of the Exchequer Court in *Wertman* v *MNR*, [1964] CTC 252, with the later decision of the lower-level Tax Appeal Board in *Duplessis* v *MNR*, [1971] Tax ABC 247.

[8] One can charge a lower interest rate if one can show that an arm's-length lender and borrower would have agreed to the lower rate. Most likely, this would be possible only if interest rates were falling, as a decline in the prescribed rate would generally lag behind a decline in general interest rates.

In order to rely on this rule, Wife has to actually pay the interest that has accrued during a calendar year within 30 days after the end of that calendar year.[9] Being late with any portion of the interest payment (even a cent) will render this exception unavailable with retroactive effect. If setting up such a loan, it is crucial to ensure that the creditor spouse pays all interest due as soon as possible after the end of each calendar year while any amount is owing under the loan. Given that the onus of proof is always on the taxpayer, of course, the spouses have to document that interest payment and retain proof that the interest payment was made. This can be as simple as keeping a photocopy of the cheque written from the bank account of the debtor spouse to the bank account of the creditor spouse.

Of course, each spouse needs to have a separate account so that the payment can easily be proven.

Fair Market Value Sales Between Spouses

As noted, a transfer of property includes a sale of the property (even at fair market value). In order to avoid attribution in respect of property that is sold at fair market value, the following criteria must be satisfied.[10]

(a) The recipient must pay fair market value consideration.

(b) To the extent that the recipient issues a promissory note or other debt as consideration, a fair market value rate of interest must apply and all interest that has accrued in a calendar year must be actually paid within 30 days of the end of the year (same rule as for fair market value loans).

(c) The transferor spouse must elect out of the spousal rollover provisions and trigger any capital gain that has accrued on the property.

Attribution will apply if the recipient pays fair market value consideration but the transferor spouse relies on the spousal rollover rules to avoid triggering a capital gain.

Separation and Divorce

Attribution of income does not apply while spouses are living separate and apart as a result of a breakdown in their relationship.[11] This exclusion applies automatically.

Separated spouses must file a joint election in order to avoid attribution of capital gains while the spouses are living separate and apart.[12] The joint election can be filed in the year in which the

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[9] ITA section 74.5(2).

[10] ITA section 74.5(1).

[11] ITA section 74.5(3)(a) in respect of the general spousal attribution rules and ITA section 74.5(4) in respect of the so-called corporate attribution rules.

[12] ITA section n74.5(3)(b).

capital gain is triggered or any preceding year.

Of course, attribution ceases to apply once spouses are no longer spouses.

Back-to-Back Loans and Transfers

A back-to-back loan or transfer occurs in the following situations.[13]

(a) X lends or transfers property to Y and any person (not just Y) lends or transfers that same property (or substituted property) to or for the benefit of X's spouse.

(b) X lends or transfers property to Y on condition that any property (not just the property that X loaned or transferred) be loaned or transferred by any person (not just Y) to X's spouse.

If a back-to-back loan or transfer occurs, the attribution rules will apply as if X had made the loan or transfer directly to X's spouse.

In applying the fair market value transfer exception, any consideration received by an intermediary party will be deemed to have been received by X.

For example, assume the following scenario.

(a) X sells an asset with a fair market value of $10,000 to unrelated third party Y.

(b) Y sells the asset to unrelated third party Z.

(c) X's spouse purchases the asset from Z at a time when the asset has a value of $15,000.

If Z sells the asset to X's spouse for less than its $15,000 fair market value, attribution will apply and any income or capital gain realized by X's spouse in respect of the asset will be taxed as income or capital gain of X.

Guarantees

A deeming rule also applies if X guarantees a loan issued by any person to X's spouse.[14] In this case, X will be deemed to have made the loan directly to X's spouse.

Attribution will not apply if the interest rate on the loan is equal to at least the prescribed rate of interest that was in effect at the time of the loan and at least that amount of accrued interest is actually paid within 30 days after the end of each year. However, no credit will be received for

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[13] ITA section 74.5(6).

[14] ITA section 74.5(7).

any interest that is paid by X (rather than by X's spouse).[15]

TFSA and Other Exceptions

The ITA provides for a number of specific exceptions from the attribution rules for contributions to registered plans. To the extent that statutory contribution limits apply in respect of the contributions, of course, the exception from the attribution rules generally apply only to the extent that the statutory contributions limits are respected.

1. If a high-income spouse contributes funds to a spousal RRSP for a low-income spouse, any income earned in the spousal RRSP is not attributed back to the contributor.[16] However, a special attribution rule applies if the spouse withdraws funds from the spousal RRSP in the year of the contribution or in one of the following two years.[17] In this case, the contributions made by the high-income spouse in that year and the preceding two years (up to the withdrawn amount) are included in the income of the high-income spouse.

2. No attribution applies if one spouse transfers or loans funds to the other spouse and the other spouse contributes the funds to a TFSA. [18] As a result, a high-income spouse can lend funds to a low-income spouse so as to enable the low-income spouse to contribute to a TFSA. Of course, appropriate tracing measures should be in place so as to prove that the loan was contributed to the TFSA of the spouse. As well, this rule does not prevent attribution from applying after funds are withdrawn from the TFSA.

3. Attribution does not apply in respect of amounts contributed to a prescribed provincial pension plan for a spouse.[19]

4. Attribution does not apply in respect of amounts contributed to a registered disability savings plan (whether for a spouse or a Tax Minor).[20]

Generally, no attribution applies in respect of amounts that are deductible in computing the income of the payer provided that the amount is required to be included in the income of the recipient.[21]

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[15] ITA section 74.5(7)(b).

[16] ITA section 74.5(12)(a).

[17] ITA section 146(8.3).

[18] ITA section 74.5(12)(c).

[19] ITA section 74.5(12)(a.1).

[20] ITA section 75.5(12)(a.2).

[21] ITA section 74.5(12)(b).

ANTI-AVOIDANCE RULES

Before moving on to how the general attribution rules apply in respect of Tax Minors, I should briefly review some anti-avoidance considerations.

The spousal attribution rules do not contain a purpose test. They apply automatically whenever there is a loan or transfer from one spouse to the other. If not for a specific anti-avoidance rule, this lack of a purpose test would allow a low-income spouse to transfer assets to a high-income spouse and have income and capital gains generated by the transferred asset to be taxed at the rate of the low-income earner (reverse attribution, so to speak).

This reverse attribution is prevented by a specific anti-avoidance rule.[22] This prevents the application of the general (no purpose test) attribution rules if one of the main purposes of a transaction is to reduce tax.

Besides this specific anti-avoidance rule, any scheme that involves the attribution rules must survive application of the general anti-avoidance rule ("**GAAR**").[23] GAAR applies if a transaction results in a tax benefit that can be characterized as a misuse or abuse of the provisions of the ITA.

It is beyond the scope of this paper to analyze GAAR in any detail. However, I will discuss the Supreme Court of Canada decision in *Lipson*.[24] This case applied GAAR to a spousal transfer and has sparked considerable controversy among commentators.[25]

The case involved transactions between a husband and wife. The wife purchased shares of the husband's corporation from the husband and mortgaged the family home in order to pay the purchase price. While this was a fair market value purchase, the husband did not elect out of the spousal rollover rules and so did not recognize a capital gain on the transaction. Accordingly, the attribution rules applied to the shares acquired by the wife. As well, the husband had guaranteed the loan taken out by the wife (another reason for the attribution rules to apply).

The interest payable on the loan resulted in annual losses on the shares, as the interest expense exceeded the dividend income generated by the shares. While the loss was the wife's loss, the husband deducted the loss on the basis that the attribution rules applied to attribute the loss back

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[22] ITA section 74.5(11).

[23] ITA section 245.

[24] *Earl Lipson* v *The Queen*, [2009] 1 C.T.C. 314, 2009 D.T.C. 5528 (SCC).

[25] See David Louis, "Personal Tax Planning — Spousal Flips and Income-Splitting Loans", *CCH Estate Planner Newsletter*, February 2009 (Number 169); Paragraph 11,370 of the CCH *Canadian Estate Planning Guide*; Olivier Fournier and Michael N. Kandev, "Lipson (SCC) — A Unanimously Divided Supreme Court", *CCH Tax Topics*, January 22, 2009 (Number 1924); Paul Hickey and Mark Meredith, "SCC GAARs Lipson Spousal Attribution Plan" (2009) vol. 17, no.2 *Canadian Tax Highlights*, 2; Brett Anderson, "Lipson: Certainty and Predictability or Certainly Unpredictable?" in *Tax for the Owner-Manager* (2009) Volume 9, Number 2, page 4; Michael D. Templeton, "The Supreme Court Revisits GAAR" in *Canadian Tax Journal* (2009) Volume 57, Number 1 (Current Cases Feature).

to the husband. Of course, the husband deducted the loss against his other income.

The Canada Revenue Agency reassessed the husband to deny the deduction of the losses and used GAAR to justify the reassessment. The case wound its way through the appeal process on this basis and eventually came before the Supreme Court of Canada.

At the Supreme Court, Rothstein J took the position that the prohibition against reverse attribution applied to deny deduction of the losses by the husband.[26] The other six judges dealt solely with the GAAR analysis on the basis that the parties to the appeal had agreed that the reverse attribution prohibition did not apply.[27] Since the parties had not argued the reverse attribution prohibition, six of the seven judges did not address the reverse prohibition provision (leaving the interpretation of that provision to another day).

In the result, the majority of the court applied GAAR on the basis that attribution of the interest expense to the husband was abusive. In fact, the majority left the husband with the worst of both worlds: income on the shares was attributed to the husband (so dividends would be taxed at his higher rate) but the interest deduction remained with the wife. This attribution of income but not of the expense has been criticized by a number of commentators and seems to be in the nature of a penalty.

Many commentators think that *Lipson* will be confined to its specific facts. At first blush, it seems that the court might have been wiser to have required argument on the reverse attribution provision in order to make sure that this targeted rule did not apply before getting into the GAAR analysis. Arguably, the reverse attribution prohibition should have applied so that the dividend income and the interest expense remained with the wife. Be that as it may, the case is a decision of the top court in the country and needs to be taken into account when working with the attribution rules. While commentators are not clear as to the exact principle that the case stands for, it should perhaps be taken as a warning not to be "too cute" with the attribution rules.

TRANSFERS AND LOANS TO TAX MINORS: ATTRIBUTION OF INCOME

The rules in respect of tax minors are set out in ITA section 74.1(2).

By "tax minors", this paper is referring to an individual who

(a) is under the age of 18 (in other words, age 17 or younger) at the start of the calendar year in question; and

(b) will not reach the age of 18 before the end of the calendar year in question.

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[26] See paragraphs 100 to 124 of the *Lipson* reasons for judgment.

[27] See paragraph 43 (majority reasons of Lebel J) and paragraph 61 (dissent given by Binnie J) of the *Lipson* reasons for judgement. If GAAR is supposed to be a provision of last resort, it is puzzling to see a court jump into a GAAR analysis without even analyzing whether a specific targeted anti-avoidance provision applied.

The attribution rules apply strictly for income tax purposes, so the age at which a child reaches adulthood under provincial legislation is irrelevant.[28]

Attribution applies only in respect of the following tax minors.

(a) A tax minor who does not deal at arm's length with the transferor/lender.

(b) A tax minor who is the niece or nephew of the transferor/lender

Individuals who are related for income tax purposes are deemed to deal with each other on a non-arm’s-length basis.[29] Accordingly, a tax minor can never deal at arm’s length with the tax minor’s parent or grandparent. For general income tax purposes, uncles and aunts are not related to their nieces and nephews. However, uncles and aunts are specifically deemed to deal on a non-arm’s-length basis with their nieces and nephews for purposes of the attribution rules.

If a tax minor is not related to the transferor/lender and is not the niece or nephew of the lender/transferor, it is still possible for the tax minor to be dealing on a non-arm’s-length basis with the lender/transferor as a matter of fact. This may well be an issue whenever an adult extends an interest-free loan or a monetary gift to any tax minor.

With a very significant difference, the attribution rules for tax minors are very similar to the attribution rules for spouses. However, attribution in respect of tax minors applies only in respect of income generated from the lent or transferred property. No attribution applies in respect of capital gains. Accordingly, a mother could gift cash to a trust for her 5-year old child. If the trust invested the cash in a growth mutual fund that is designed to generate only capital gains, no attribution would apply on the capital gains. Of course, attribution might apply in respect of any incidental income (interest or dividends) generated while the tax minor is a tax minor.

As well, no attribution applies in respect of child tax benefits[30] or universal child care benefit amounts[31] that are lent or transferred to a tax minor. Of course, one has to be able to trace the benefit amount to a loan or transfer to or for the benefit of the tax minor in order to rely on this exclusion.[32]

As noted, attribution ceases to apply in respect of a tax minor as of the start of the year in which

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[28] In British Columbia, an individual becomes an adult on reaching the age of 19 (not 18).

[29] ITA section 251.

[30] Paid under ITA sections 122.6 to 122.64 and excluded from the attribution rules by ITA section 74.1(2).

[31] Paid under section 4 of the Universal Child Care Benefit Act and excluded from the attribution rules by ITA section 74.1(2).

[32] See paragraph 16 of Information Circular 79-9R, which deals with attribution and family allowance payments (now replaced by the child tax benefit and the universal child care benefit). Presumably, the tracing principles discussed in that paragraph will apply to the newer benefits.

the tax minor reaches age 18. Accordingly, no attribution applies in respect of stub period income earned between the start of the calendar year that includes the 18th birthday and the date of the individual's 18th birthday. However, reaching age 18 results in emancipation from the attribution rules only in respect of transferred property. A separate set of attribution rules applies in respect of income generated by interest-free and low-interest loans made to a non-spouse. See the discussion under the heading "Loans to Non-Spouse Grown-Ups".

The attribution rules do not apply to the extent that an amount is taxed under the "kiddie tax" rules.[33] The "kiddie tax" rules generally apply in respect of income that is sourced from private family corporations or that is generated through efforts of a parent. Those rules would generally not apply to income that is generated from arm's-length or publicly-traded investments (hence the continued need for the attribution rules).

The back-to-back and guarantee deeming rules also apply in respect of tax minors.

LOANS TO NON-SPOUSE GROWN-UPS: ATTRIBUTION OF INCOME

Literature on the attribution rules can lead one to conclude that attribution ceases in the year that a minor turns 18. This is a problem of buzz words, which often refer to attribution in respect of minors. However, turning 18 merely results in a different set of rules applying. For lack of a better term, this paper will refer to these rules as the attribution rules for Non-Spouse Grown-Ups.

These rules are contained in ITA section 56(4.1) and apply only in respect of low-interest or interest-free loans or debt. To the extent that income is generated by transferred (including gifted) property, attribution ceases in the year that the tax minor reaches age 18. However, attribution continues if the income is generated by an interest-free or low-interest loan or debt.

The Non-Spouse Grown-Up attribution rules have the following features.

(a) The rules apply whether or not attribution applied while the individual was a tax minor. For example, assume that a parent makes an interest-free loan to an adult child who is 25 years old. If the loan has an income-splitting purpose and the adult child receives income generated by investing the loan, the income earned by the adult child will be taxed as income of the parent.

(b) The rules apply only in respect of income. They do not apply to capital gains.

(c) As expected, the rules apply only in non-arm's-length situations. However, no rule deems uncles and aunts to be dealing with nieces and nephews on a non-arm's-length basis. In the year that a nephew or niece turns 18, the nature of the relationship will be a question of fact. However, it may be difficult to convince anyone that an arm's-length relationship exists if an uncle has extended an interest-free loan to his niece.

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[33] ITA section 74.5(13).

The Non-Spouse Grown-Up attribution rules apply only if a purpose test is met. In contrast, the attribution rules for spouses and tax minors do not contain a purpose test (the income-splitting objective is presumed under those rules). The purpose test is satisfied if one of the main reasons for the loan is to reduce or avoid tax by causing income from the loaned property to be included in the income of the Non-Spouse Grown-Up. While this may give one some scope for avoiding application of the rules, tax reduction need be only "one of the main purposes" for the existence of the loan or debt. In other words, the lender has to prove that the main purposes of the loan or debt did not include tax reduction. This may be a difficult challenge if tax reduction resulted from the loan or debt. While it may be possible to prove that the tax reduction was an unexpected and incidental benefit, a court is likely to be suspicious of any such argument.

As with the attribution rules for spouses and tax minors, attribution will not apply if the loan bears an interest rate that is at least equal to the CRA prescribed rate that is in effect at the time that the loan is made.[34] Of course, the interest due under the loan has to be paid within 30 days after the end of each year. Being late by even a single day can make this exclusion inapplicable on a retroactive basis. If one is careful to make and document the interest payments, however, one can extend a loan at the current low prescribed rate of 1% and lock that rate in for a number of years (even if the prescribed rate rises in future).

REVERSIONARY TRUSTS

ITA section 75(2) contains an attribution rule that applies to reversionary trusts.

If a person contributes property to a trust and the property is held in the trust subject to certain conditions, any income or capital gain from the contributed property is treated as income or capital gain of the contributor.

This rule is described in detail in the paper being presented by ***. Accordingly, I refer you to that paper.

CORPORATE ATTRIBUTION RULE

The so-called corporate attribution rule is contained in section 74.4 of the ITA.[35]

I use the adjective "so-called" because the corporate attribution rule is really a form of minimum tax rather than an attribution rule in the strict sense of the term. The corporate attribution rule creates and taxes deemed income (even when no actual income exists).

Basic Rules

The corporate attribution rule applies if the following tests are met.

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34 ITA section 56(4.2).

35 For a detailed discussion of these rules, see Paul W. Festeryga, "Corporate Attribution: The Anti-Freeze Rule", 2010 *Canadian Tax Journal*, issue 3 (Personal Tax Planning Feature).

5. An individual (the "**Transferor**") transfers or lends property to a corporation. The transfer or loan can be direct or indirect.

6. One of the main purposes of the transfer is to reduce the income of the Transferor and to confer a benefit on a "Designated Person" in respect of the Transferor.

If the above tests are satisfied, the Transferor will be deemed to receive income each year based on the non-cash consideration taken back on the transfer to the corporation.[36]

The above tests will almost always be met in a typical estate freeze because Designated Persons will invariably hold an interest (usually through a family trust) in the future growth in the value of the corporation.

For example, assume the following simple estate freeze scenario.[37]

> Father owns all the shares of a corporation ("**Rco**") that holds rental real estate. Rco has fewer than 5 full-time employees. As a result, Rco does not earn active business income that is taxed at the low corporate rate. Father decides to conduct an estate freeze by exchanging all his common shares of Rco for new fixed-value redeemable retractable shares with an aggregate redemption value equal to the value of the assets of Rco (assume $1 million). These shares act like a sponge and absorb all the value of Rco. This allows Rco to issue new common shares to a discretionary family trust, the beneficiaries of which consist of the adult children and the other descendants (including minor descendants) of the father. The share exchange is conducted on a tax-deferred basis under section 86 of the ITA. In order to avoid the attribution rules discussed above, the trust is established by a family friend who contributes a $100 bill or a gold coin. The trust then borrows $75 from another friend and pays the prescribed rate of interest on that loan. The trust uses the loaned funds to buy its new common shares. Shortly after completion of the reorganization, the trust receives a dividend on its common shares and uses that dividend to repay the loan (and to pay the accrued interest on the loan).

This is typically illustrated as follows.

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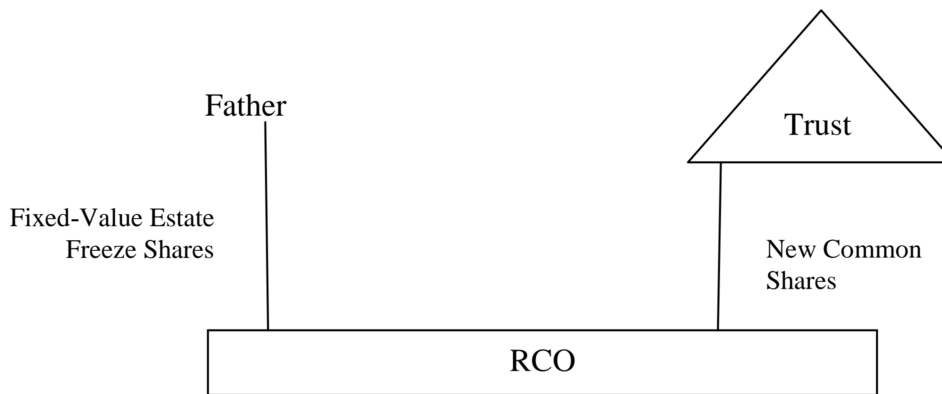
[36] The deemed income arises only if certain other tests are met. These other tests will be dealt with in the discussion that follows.

[37] I am assuming that the mother does not own any shares of the corporation. This is primarily to simplify the example. In many cases, of course, both parents will exchange common shares for fixed-value shares.



By exchanging his common shares for the fixed-value shares, the father is transferring property – his common shares – to Rco. Of course, the purpose of the estate freeze is to have future growth in value accrue to the subsequent generations of the family. It would be difficult to argue that the purposes of the estate freeze did not include the reduction of the income of the parents and the conferral of a benefit on the members of the subsequent generation. This purpose just has to be one of the main purposes – not the primary main purpose.

If the corporate attribution rule applies, the father is deemed to receive interest income during each year in which the provision applies. This is an *annual* deemed income inclusion and applies whether or not Rco pays any amount to any member of the family.

The deemed interest income is based on the non-cash consideration taken back by the Transferor. In the above example, the non-cash consideration taken back consists solely of the fixed-value shares received by the father, so the deemed interest income is based on the aggregate redemption value of those fixed-value shares. The deemed interest is equal to that aggregate redemption amount multiplied by the Canada Revenue Agency prescribed rate of interest. The fixed-value shares have an aggregate redemption value of $1 million and the current prescribed rate of interest is 1%. As a result, the annual deemed income is equal to 1% of $1 million, or $10,000.

In calculating the deemed interest, one uses the prescribed rate that is in effect from time to time (not just the rate in effect at the time of the share exchange). If the prescribed interest rate were to increase to 3% as general interest rates recover with the economic situation, the annual deemed income would also rise from $10,000 to $30,000 (assuming no redemption of any fixed-value shares).

The annual deemed income for any year is reduced by the grossed-up amount of any actual (but not deemed) dividends received by the father on his fixed-value shares in that year. Accordingly, the father can avoid the deemed income simply by receiving at least $10,000 worth of grossed-up dividends annually on the fixed-value shares (assuming that none of the fixed-value shares are redeemed and that the prescribed rate stays at 1%). The actual amount of dividends would be less than $10,000, as one reduces the deemed dividend by the amount of the

dividend included in income after applying the gross-up.[38]

Of course, this assumes that the fixed-value shares are eligible to receive a dividend equal to the required amount. When doing an estate freeze, it is prudent to ensure that the fixed–value shares taken back on the estate freeze are eligible to receive a non-preferential discretionary dividend that is no greater than the CRA prescribed rate (as in effect from time to time) multiplied by the aggregate redemption amount.[39] If section 74.4 is applicable in respect of any period of time, the corporate directors can then declare a dividend on the fixed-value shares so that tax is paid on actual income rather than on deemed income. It is always better to pay tax on an amount that is actually received than to pay tax on a non-receipt.

As noted, the corporate attribution rule is not an attribution rule in the strict sense of the term because the father is deemed to receive income even if Rco does not pay any income at all on any of its issued shares. As a result, the corporate attribution rule is also referred to as a phantom income rule. In reality, is a form of minimum tax. As long as the father receives at least the required amount of dividends on his fixed-value shares each year, he can split as much income as he wants with the members of the subsequent generations. This is subject, of course, to the application of the so-called "kiddie tax", so the income-splitting is effectively limited to children and other descendants who are at least 17 years old on January 1 of the year in question.

Only actual dividends on the fixed-value shares serve to reduce the deemed income that would otherwise arise. Deemed dividends triggered by a redemption of the fixed-value shares do not count. If the plan involves a wasting estate freeze in which the fixed-value shares are redeemed over time (so as to reduce the capital gain that will be realized on the death of the surviving parent), it will be necessary to time the annual redemptions so that sufficient dividends can be paid each year to eliminate any phantom income that would otherwise arise.

If fixed-value shares have been redeemed, the phantom income is calculated on the remaining redemption value of the fixed-value shares (not the original redemption value). Accordingly, the amount of the annual dividend required will go down as fixed-value shares are redeemed (assuming no change in the CRA prescribed rate). Of course, the CRA prescribed rate is re-set every calendar quarter. As general interest rates recover to higher levels, the CRA prescribed rate will also rise.

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[38] The amount of the gross-up depends on whether the dividend is an ordinary taxable dividend (25% gross-up) or an eligible dividend (41% gross-up in 2011). The purpose of the gross-up is to make the grossed-up amount of the dividend approximate the income that was originally earned by the corporation. The individual then calculates tax based on the grossed-up amount but claims a dividend tax credit on the assumption that the corporation paid tax when it earned the original income. The dividend tax credit gives the shareholder credit for the tax that the corporation is assumed to have paid on the original income. As a result, the rate of tax paid by the shareholder on a Canadian-source dividend is lower than the rate of tax paid on ordinary income.

[39] While the deemed income is reduced by the grossed-up amount of the dividend rather than the actual dividend, it is easier to base the dividend rate on the prescribed rate. If the directors can declare a dividend up to the prescribed rate, they can choose to pay a lower dividend that will generate the desired amount of grossed-up dividend.

As noted, the deemed interest income is based on the non-cash consideration taken back by the Transferor. The earlier example was based on an exchange of shares in which the sole consideration received back by the father was fixed-value shares of Rco. If the father had been transferring real estate to Rco on a tax-deferred basis under section 85 of the ITA, of course, the father would generally also have received back non-share consideration (such as a promissory note or the assumption of debt by the corporation) up to the tax cost of the transferred property. In this case, the deemed income would be based on the aggregate of the redemption amount of the fixed-value shares, the promissory note and the assumed debt. While paying down the promissory note would reduce the base on which the deemed interest is calculated, payments of principal would not count toward reduction of the deemed income inclusion.

If the consideration taken back includes both a promissory note and fixed-value shares, one could provide for interest on the promissory note equal to the CRA prescribed rate as well as discretionary dividends on the fixed-value shares up to the CRA prescribed rate. However, there is no need to pay interest on the promissory note if the shareholder does not want to receive interest. In this case, however, it will be important to ensure that the dividends payable on the fixed-value shares can generate enough dividends to take care of the deemed income generated by both the shares and the promissory note. This will require an adjustment to the dividend rate on the fixed-value shares.

To the extent that the non-share consideration includes the assumption of debt owing to a third party, any interest paid by the corporation to the third party will not reduce the deemed income amount. In this case, the deemed income generated by the assumed debt amount will have to be reduced by dividends on the shares. Again, this will require adjustments to the dividend provisions of the fixed-value shares.

If Both Spouses are Transferors

In the example used earlier, the father was the sole individual who transferred property to Rco. This was in order to simplify the example. However, both spouses will often be transferring property to the corporation. If both spouses hold common shares of the corporation and the transaction is an estate freeze, both spouses will usually participate in the estate freeze. This may mean that each spouse will exchange common shares for fixed-value shares. Of course, each spouse will be a Designated Person in respect of the other spouse.

If both spouses are transferring property to the corporation, it is important to ensure that there is no change in the economic position of the spouses *vis-a-vis* each other and the corporation. This will require careful attention to the share conditions of the fixed-value shares. If the spouses held the same class of share prior to the freeze, they should hold the same class of freeze shares after the freeze (so that any dividends paid on the fixed-value shares after the freeze are shared between the spouses in the same proportions as would have been the case on the common shares before the freeze). There would also have to be a requirement for a pro-rata redemption of any shares so that the appropriate dividend ratio is maintained.

More likely, each spouse will have a separate class of common shares prior to the freeze and the corporation will have been able to sprinkle dividends to one spouse or the other. In this case, it will be trickier to ensure that there has been no change in economic position.

Payment of Annual Dividends

The payment of annual dividends on the fixed-value shares is seemingly an easy way to deal with the corporate attribution rule given that the CRA prescribed rate is so low at the moment. However, the CRA prescribed rate will inevitably rise over time. If you plan to deal with ITA section 74.4 by the payment of annual dividends, you need to project whether the corporation will still be able to pay those annual dividends if the prescribed rate rises in future. As nobody has a reliable crystal ball, it would be imprudent to assume that the prescribed rate will always stay at its current rate. In the past, we have had double-digit prescribed rates.

Fortunately, there are other ways to avoid the application of ITA section 74.4.

Exception for Active Business Corporations

As noted, section 74.4 can apply only if there has been a transfer to a corporation. During any period of time that the transferee corporation is a "small business corporation", section 74.4 will not apply.

A "small business corporation" is a Canadian-controlled private corporation that uses substantially all its assets (measured by fair market value) in an active business carried on primarily in Canada. Because such a corporation is not necessarily "small", I prefer to use the term "active business corporation". However, the technical requirement is based on the small business corporation concept in the ITA.

If the transferee corporation does not qualify as an active business corporation, of course, this exception is not available. Even if the exception is available at the time of the transfer, however, the transferee corporation must continue to qualify as an active business corporation for this exception to apply. If the transferee corporation ceases to qualify, the exception ceases to apply. A transferee corporation would cease to qualify as an active business corporation for any number of reasons. The corporation could sell its business or simply accumulate too high a proportion of non-active assets by establishing a sinking fund for a future expansion of the business.

If one is relying on the exception for active business corporations, this reliance requires constant vigilance to ensure that the corporation continues to qualify for the exception.

No Benefit to a Designated Person (Safe Harbour Exception)

Section 74.4 can apply only if the other shareholders of the transferee corporation include "Designated Persons" in respect of the Transferor individual and those Designated Persons meet certain shareholding tests. If the Designated Persons are beneficiaries of a discretionary trust, however, the Designated Persons will almost always meet the shareholding test.

A "Designated Person" is defined in relation to the Transferor and consists of the following individuals.[40]

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[40] ITA section 74.5(5), when read in conjunction with the definition of "designated person" in ITA section 74.4(1).

(a) The spouse of the Transferor.

(b) An individual who is under 18 years of age and who

(i) does not deal at arm's length with the Transferor; or

(ii) is a niece or nephew of the Transferor.

Individuals are deemed to deal with each other on a non-arm's-length basis if they are related to each other (for example, a parent and a child are related to each other). For unrelated individuals, it is a question of fact whether they deal on a non-arm's-length basis.

Uncles and aunts are not related to their nieces and nephews. Therefore, the Designated Person definition specifically includes nieces and nephews (even if the niece or nephew factually deals at arm's-length with the Transferor uncle or aunt).

Section 74.4 will not apply if all Designated Persons hold all their interests exclusively through a trust, the terms of the trust prohibit the Designated Person from receiving or otherwise obtaining any benefit from the trust while the individual is a Designated Person in respect of the Transferor and the individual has not in fact obtained any such benefit while the individual is a Designated Person.[41] This exception is commonly referred to as a "safe harbour" exception.

It may be possible to rely on this safe harbour exception by structuring the terms of the trust in the proper manner. For example, if all the Designated Persons are members of the subsequent generation, the trust can prohibit a member of the subsequent generation from benefitting under the trust while that member is under the age of 18. This means giving up the ability to pay dividends to an individual during the interval between January 1 of the year in which the individual is 17 years old at the start of that year and the 18th birthday of the individual.

However, the safe harbour exception will not be available if a spouse of the Transferor holds fixed-value shares directly in the corporation in question. If both spouses hold common shares of the corporation and are exchanging those common shares for fixed-value shares as part of an estate freeze, each spouse will end up holding fixed-value shares directly in the corporation. Of course, each spouse will be a Designated Person in respect of the other spouse.

Even though the safe harbour exception does not apply because a spouse of the Transferor holds shares directly in the corporation, the presence of the restrictions in the trust may serve to show that the purpose test is not in fact met. Of course, this assumes that the shares held by the spouse have been properly structured so that the purpose test is not met in respect of the spouse.

Stock Dividends

One technique for avoiding the application of section 74.4 is to avoid having an individual transfer any property to the corporation. In some situations (including many estate freezes), this can be accomplished by issuing a stock dividend to the current shareholders rather than having

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[41] ITA section 74.4(4).

the current shareholders exchange their existing shares for fixed-value shares.

The shares issued on the stock dividend would be fixed-value estate freeze shares with a nominal par value. As long as the stock dividend is paid to all holders of common shares and is paid proportionate to the values of those common shares, the amount of the stock dividend for income tax purposes will be the aggregate par value of the shares issued on the stock dividend. This should be a nominal amount. However, the full redemption amount of the shares may have to be included in income if the stock dividend shares are distributed to the common shareholders on anything other than a pro-rata basis.[42]

The issuance of shares on a stock dividend is an issuance of shares by the corporation and does not involve a transfer of any property to the corporation. Accordingly, section 74.4 should not apply.

After the stock dividend, the shareholders will be left with common shares with only a nominal value. Those common shares could be eliminated by having the corporation purchase the shares for cash consideration. While this does involve a transfer to a corporation, the value involved is nominal. If the corporation pays cash for the shares, there will be no non-cash consideration received by the individuals in respect of the transfer and therefore no non-cash consideration on which to base any deemed interest income.

The fixed-value shares issued on the stock dividend would contain a price adjustment provision so as to ensure that all the value of the existing common shares is taken up by the fixed-value shares. The CRA has indicated that it will not accept a price adjustment clause as part of a stock dividend freeze because such a price adjustment clause would not comply with the CRA's stated position on price adjustment clauses.[43] However, I have never seen the CRA actually take any assessment action on the basis of this position. It is difficult to see why a price adjustment clause would be respected if the clause is set out in the terms and conditions of shares issued on a share exchange estate freeze but not if the clause is set out in the terms and conditions of shares issued on a stock dividend. Even if the CRA reassessed, a properly-drafted price adjustment provision in the share conditions should provide a basis for an application for a rectification of the director resolution setting the redemption amount of the shares issued on the stock dividend.

If relying on a stock dividend freeze structure, the principal will have to be careful not to trigger any of the deemed transfer rules discussed elsewhere in this paper.

Of course, a stock dividend freeze will not be possible if an individual is transferring assets to a corporation.

A stock dividend freeze will also not be an option if the estate freeze involves the crystallization of a capital gains exemption. In that case, the corporation will be an active business corporation so that section 74.4 will apply only if the corporation loses active business corporation status at

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[42] ITA section 15(1.1).

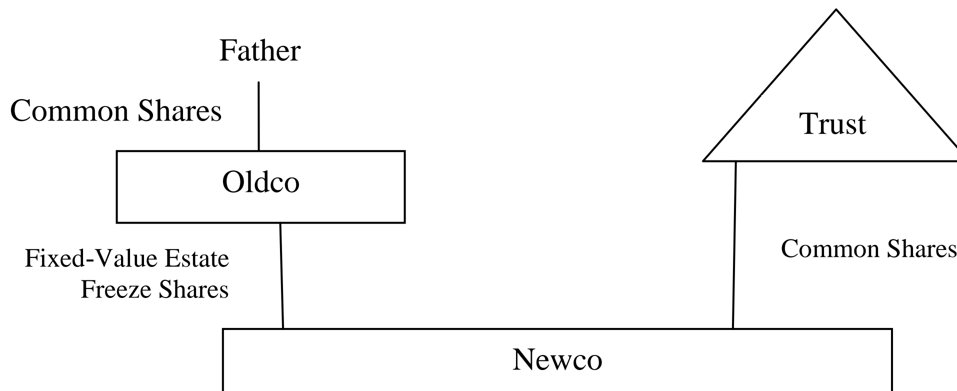
[43] See CRA technical interpretation 2003-0004125, dated April 1, 2003, and Interpretation Bulletin IT-169, "Price Adjustment Clauses," issued August 6, 1974.

some point in the future.

Drop-Down Transfers

Another way to avoid section 74.4 is to have the corporation ("**Oldco**") transfer its assets to a new corporation ("**Newco**") in return for fixed-value shares of Newco. This transfer would be effected on a tax-deferred basis under ITA section 85. The new shareholders would hold shares of Newco.

This can be illustrated as follows.



While the shareholders of Oldco continue to hold common shares of Oldco, the value of Oldco is fixed because the value of Oldco consists entirely of its fixed-value shares in the capital of Newco. As long as this is the case, the common shares of Oldco will not grow in value.

Section 74.4 would not apply in this situation because the shareholders of Oldco would not have transferred any property to a corporation. This presumes, of course, that the transfer of assets from Oldco to Newco is not an *indirect* transfer of assets by the shareholders of Oldco. This will be a question of fact. If the shareholders of Oldco transferred assets to Oldco and then, as part of that same series of transactions, caused Oldco to transfer the assets to Newco, the transfer of the assets from Oldco to Newco would likely be an indirect transfer of assets by the shareholders of Oldco. This will be a question of timing and other relevant circumstances. The more time that elapses between the two transfers, the better – but no specific period of time will provide absolute insulation from this characterization. It will all depend on the facts.

PRINCIPAL RESIDENCE EXEMPTION

A few years ago, it was fashionable to hold the family cottage in a trust. This may have gone out of fashion for various good reasons, but I will use this as an example to illustrate an attribution rule that applies specifically to the principal residence exemption.

As we all know, an individual does not pay capital gains tax on the sale of a home that has

always been used as the individual's personal residence. A family unit – father, mother and minor children – can have only one principal residence in any one year.

A trust can also claim the principal residence exemption. If the trust claims the exemption, however, it must specify each trust beneficiary (a "**specified beneficiary**") who ordinarily inhabited the residence or who had a spouse, former spouse or child (including an adult child) who ordinarily inhabited the residence.[44] For this purpose, a trust beneficiary includes a person who has a mere contingent interest in the trust. If the trust claims the principal residence exemption in respect of a cottage, each specified beneficiary of the trust is deemed to have claimed the cottage as his or her principal residence as well.[45]

This can cause a significant problem. Assume that a family cottage trust claims the principal residence exemption in respect of the family cottage for the years 2000-2010. If each sibling is a beneficiary of the trust and has used the cottage for a part of each year, each sibling will be considered to have claimed the cottage as the sibling's principal residence for the years 2000-2010. This means that no sibling will be able to claim the principal residence exemption in respect of that sibling's own personal residence for the years 2000-2010.

The problem can also arise in other contexts. Assume that a joint spousal trust holds the personal residence of Mr. and Mrs. Taxpayer, who have an adult child named Trevor. As Trevor lives some distance away, Trevor's children visit their grandparents for a month each summer. Trevor is a beneficiary of the joint spousal trust after the death of the survivor of Mr. and Mrs. Taxpayer. If the joint spousal trust claims the principal residence exemption on the death of the surviving spouse, will this preclude Trevor from claiming the principal residence exemption in respect of his own residence? This depends on whether the children of Trevor have "ordinarily inhabited" the residence of the grandparents during those annual summer visits. There is a strong argument that they have.

In the absence of the above rules, a father could create a trust to hold a house in which an adult child resides while going to university. After the child is through university, the trust could sell the house, claim the principal residence exemption and distribute the tax-free sale proceeds to the father. Because of the principal residence attribution rules, however, the father will be unable to claim his own personal home as his principal residence for the years that the trust held the property in which the child resided. I suspect that the rule is in place to prevent doubling-up on the principal residence exemption, but the rule can trap unwary taxpayers.

If your clients hold a cottage or a personal residence in a trust, it is possible to roll the residence to a beneficiary and have the beneficiary claim the principal residence exemption (assuming that the beneficiary does not have a personal residence on which the beneficiary wishes to claim the exemption). Of course, the sale proceeds would then belong to the beneficiary who sold the property.

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[44] See subparagraph (c.1)(ii) of the definition "principal residence" in ITA section 54. Read this together with the definition of "beneficially interested" in ITA section 248(25).

[45] See paragraph (f) of the definition "principal residence" in ITA section 54.

CONCLUSION

The attribution rules can be complex. I hope that this brief survey of the attribution rules will be of some assistance in your estate planning endeavours. If not, please let me know and I will ask the organizers of the conference to attribute this paper to some other author.