US TAX REFORM ERROR AFFECTS CANADIAN ESTATE FREEZES FOR US PERSONS

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The sweeping US tax reform enacted at the end of 2017 was hastily done. The first version of the tax reform bill was pro- posed in the US House of Representatives on November 2, 2017, and fewer than two months later, on December 22, 2017, President Trump signed into law the Tax Cuts and Jobs Act (TCJA, HR 1). By comparison, the previous major US tax over- haul, the Tax Reform Act of 1986, took two years. Given the speed of the TCJA's enactment, mistakes were bound to occur. The deletion of the definition of a "family-owned corporation" under IRC section 447(d)(2)(C)(i) seems to be one of those mis- takes, which may affect a US person in a Canadian estate freeze.

In a typical Canadian estate freeze, a CCPC shareholder exchanges his or her common shares for special shares. If the shareholder is a US person, the transaction must also qualify as a recapitalization for US federal income tax purposes in order to avoid triggering a gain.

To avoid a gain, US persons must exchange their stock solely for stock. Under these rules, "nonqualified preferred stock" (NQPS) received in exchange for stock that is not NQPS is not stock. Thus, US persons who receive NQPS in exchange for their common stock engage in a taxable transaction for US federal income tax purposes; however, the general rule regarding NQPS does not apply in the context of a recapitalization of a "family-owned corporation." As a result, because special shares for Canadian tax purposes generally constitute NQPS, a US person who engages in a Canadian estate freeze must qualify under the family-owned corporation exception to avoid triggering US tax.

IRC section 354(a)(2)(C)(ii)(I) provides the exception discussed above by defining a "family-owned corporation" by reference to section 447(d)(2)(C)(i). The TCJA, however, deleted that latter provision, which means that the Code currently contains no definition of a "family-owned corporation." Prior to the TCJA, a corporation was a "family-owned corporation" if at least 50 percent of the total combined voting power of all classes of stock entitled to vote and at least 50 percent of the value of all other classes of stock were owned by members of the same family

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throughout the eight-year period beginning on the date that is five years before the date of the recapitalization.

Aside from borrowing that definition, section 447 has no bearing on section 354, which excepts a family-owned corporation from the general NQPS rules. Section 447 in general provides accounting method rules for farming corporations, and before the TCJA, section 447(d)(2)(C) made an exception allowing certain family farming corporations to use the cash method of accounting if they had gross receipts that did not exceed $25 million. (Under the general rule pre-TCJA, a farming corporation could not use the cash method if it had gross receipts that exceeded $1 million.) Because the TCJA generally increased the gross-receipts test to $25 million for the purposes of allowing any type of corporation to use the cash method of accounting, the exception for family farming corporations became unnecessary, and section 447(d)(2)(C) was therefore deleted from the Code by Congress.

Despite that deletion of section 447(d)(2)(C)(i), we do not believe that Congress intended to eliminate the NQPS exception under section 354(a)(2)(C)(ii)(I). Neither the Conference Report to the TCJA nor the Joint Committee on Taxation's General Explanation of the TCJA mentions the latter. Instead, it seems that in deleting section 447(d)(2)(C)(i), Congress simply overlooked the fact that unrelated Code sections (namely, section 354(a)(2)(C)(ii)(I)) relied on the definition in the former.

After discovering that the IRC no longer provided a definition of a "family-owned corporation" for the purposes of the NQPS exception under section 354(a)(2)(C)(ii)(I), my colleagues and I have closely watched whether this error would be addressed by Congress, the US Treasury, or the IRS. On November 27, 2018, US House Ways and Means Committee Chairman Brady released a proposed bill with technical corrections to the TCJA, but, unfortunately, this issue was not addressed. Thereafter, we contacted the IRS Office of Chief Counsel to inquire about the issue and learned that, at that time, we were the first practitioners to point out this issue to them. We also learned that they were unsure of how it would be corrected.

At this time, we believe that it is reasonable for a US person to rely on the definition of a "family-owned corporation" that existed under section 447(d)(2)(C)(i) before the TCJA's enactment: a US person engaging in a Canadian estate freeze can still qualify under the NQPS exception. Because there is no suggestion that the US Congress intended to eliminate the NQPS exception under section 354(a)(2)(C)(ii)(I), we believe this is the correct approach. That said, there remains some risk for a US person at this time, because the Code does not currently provide a definition of a "family-owned corporation." We will need to wait and see how Congress, the US Treasury, or the IRS addresses this matter.