**STEP Round Table - 2004 Annual Conference**

**Topic 1 – Trust Roll-out**

If a discretionary trust makes a distribution to a beneficiary of the trust will the rollover rules contained in subsection 107(2) apply? In other words, does this subsection apply in a situation where a personal trust distributes property to a beneficiary whose capital interest or right to receive property from the trust is subject to the exercise of any discretion by the trustee.

**CRA Response:**

In general terms, subsection 107(2) provides a series of rules that apply when a personal trust distributes property to a beneficiary and there is a resulting disposition of all or any part of the beneficiary's capital interest in the trust. That is, subsection 107(2) will apply in circumstances where there is a distribution that constitutes a disposition of a capital interest in the trust and subsections 107(2.001), 107(2.002), and 107(4) to 107(5) do not otherwise apply.

Paragraph (d) of the definition of "disposition" in subsection 248(1) provides that a disposition includes a payment that can reasonably be considered to have been made because of the taxpayer's capital interest in the trust, except where paragraph (h) or (i) of that same definition apply. Paragraph (h) has no application in this situation because the trust is a personal trust. Paragraph (i) is also not applicable as we have assumed that the distribution is not out of the income of the trust nor is it in respect of an amount designated under subsection 104(20). Therefore, pursuant to paragraph (d) of the definition of "disposition" in subsection 248(1) there has been a disposition of the beneficiary's capital interest in the trust and subsection 107(2) will apply in this particular situation, subject to the exceptions noted earlier.

You have also asked whether a different result would arise if the beneficiary had paid some amount to acquire his discretionary interest in the trust. Depending on the facts of the particular situation a different result may arise. For example, if the trust was an *inter vivos* trust, it will not qualify as a "personal trust" as defined in subsection 248(1) if the beneficiary's interest in the trust was acquired for consideration payable directly or indirectly to the trust or to any person who has made a contribution to the trust. In these circumstances, it is subsection 107(2.1), and not subsection 107(2), that will apply to the distribution by the trust.

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**Topic 2 - Interest Expense**

Given recent court decisions and legislative proposals, there is now more uncertainty about the deductibility of interest expense than before. Consider a situation where a shareholder has borrowed funds from banks at different times and has used those funds for a variety of investments in a CCPC. For instance, the shareholder may have borrowed $100,000 when the CCPC was founded and put that in by way of secured loan ("loan A"). Assume the loan to the CCPC bears no interest, but the shareholder must pay 8% interest (market rate at the time of borrowing) on that loan. Later, when the business needed to expand, the shareholder borrowed a further $150,000, half of which was invested in preferred shares, and half of which was advanced as a separate loan ("loan B"). Assume that the shareholder pays only 6% interest on this loan (market rate), and that the preferred shares have a fixed dividend rate of 5%, and the loan bears interest at 6%. Later still, the shareholder borrowed another $200,000 at floating prime rate (now 3.5%), of which half was used to acquire common shares, and half was advanced as yet another secured loan ("loan C") bearing interest at prime plus ¼%.

For each of these three distinct borrowings, there are separate loan agreements and credit facilities with the bank, with separate repayment provisions and separate interest rates.

**Questions:**

If the corporation were to consolidate all the loans to the shareholder into one new debt obligation, with a blended interest rate, and that interest rate resulted in "net income" (i.e. the interest income earned by the shareholder exceeded the aggregate interest expense that the shareholder paid on the three separate loan obligations), would there be any issue as the deductibility of the interest if in fact one of the loans called for interest payments at a rate greater than the blended interest rate on the consolidated debt instrument (for instance, a blended rate of 6.5%, when one loan bears interest at 8%)? If the current market rates were 4%, would this higher blended interest rate result in non-deductible interest? Would the result be different if the blended interest rate reflected current market rates, which are lower than the fixed rates on some of the earlier borrowings?

In the other words, how far does the tracing rule go?

**CRA Response:**

Interpretation Bulletin IT-533, Interest Deductibility and Related Issues, dated October 31, 2003 describes the requirements in order for interest to be deductible.

Subparagraph 20(1)(c)(i) of the Income Tax Act (the "Act") requires, inter alia, that interest sought to be deducted be on "borrowed money used for the purpose of earning income from a business or property". In our view, the key issues relating to interest deductibility involve ascertaining the use of borrowed money, and identifying an income-earning purpose associated with that use.

The Courts have considered the interpretation of the term "used" and in particular whether used means first used or currently used. In this regard, several decisions by the Supreme Court of Canada, notably, *Canada Safeway Ltd. v. MNR*, 1957 DTC 1239, *The Queen v. Bronfman Trust*, 1987 DTC 5059 and *Shell Canada Ltd. v. The Queen*, 1999 DTC 5669 ("*Shell"*), have made it clear that the relevant use is the current use and not the original use of the borrowed money. Furthermore, in determining the current use of the borrowed money, taxpayers must establish a direct link between the money that was borrowed and its current use. However, we may apply the indirect use test in certain circumstances as exceptions to the direct use test. Paragraphs 22 to 26 of IT-533 discuss these exceptions.

In simple situations where one property is replaced with another, such linking is straightforward. In these situations, the current use of the borrowed money is entirely with respect to the replacement property since all the proceeds of disposition from the original property are reinvested in the replacement property.

Borrowings to acquire income-yielding investments must meet the income earning purpose test in subparagraph 20(1)(c)(i) of the Act. In its decision in *Ludco Enterprises Ltd. v. The Queen*, 2001 DTC 5505, the Supreme Court indicated that that purpose is to be applied as follows: considering all the circumstances, did the taxpayer have a reasonable expectation of income at the time the investment was made (absent a sham, window dressing or other vitiating circumstances). It also mentioned that income in subparagraph 20(1)(c)(i) of the Act refers to income that is generally income that would be taxable and not net income. In applying this test, it is the Agency's view that interest on money borrowed to acquire an investment that has a stated rate of income will generally be fully deductible under paragraph 20(1)(c) of the Act. As a consequence, interest will neither be denied in full nor restricted to the amount of income from the investment.

In considering whether or not an interest rate is reasonable, consideration will be given to prevailing market rates for debts with similar terms and credit risks. Further, as stated in *Shell*, "Where an interest rate is established in a market of lenders and borrowers acting at arm's length from each other, it is generally a reasonable rate…"

Under the debt consolidation, the shareholder receives a new interest bearing investment in exchange for loans A, B and C. The new investment is the current use of the money originally borrowed to acquire loans A, B and C. Since this investment is an income producing property, the interest on the money originally borrowed will be deductible under paragraph 20(1)(c) of the Act.

We also wish to inform you that on October 31, 2003 the Department of Finance released for public comment draft proposals regarding the deductibility of interest and other expenses related to a source. The proposals include rules that require that there be a “reasonable expectation of cumulative profit” from a source that is a business or property for a taxation year in order to report the loss realized from the business or property. These new rules, if they are enacted, will be applicable to taxation years beginning after 2004. These proposed rules would not affect the deductibility of the interest under paragraph 20(1)(c) of the Act because it is an expense that is deductible in the computation of the income or the loss from a source.  However, the loss realized from a source that is a property or a business may be denied under the draft proposals.

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**Topic 3 - Allocation of Trust "Phantom Income"**

Can a trust allocate "phantom income"? Consider a situation where a family trust has advanced funds to a corporation owned by family members (some of whom are contingent beneficiaries of the trust) which is in financial distress. The loan bears interest which accrues, but which is payable only if the corporation survives a restructuring. This loan would constitute an "investment contract" under subsection 12(11). Consequently, under subsection 12(4), the trust must include the accruing interest in income. However, no amount will be payable to the trust until the conditions are satisfied. In such circumstances, the trust will have a tax liability without any cash to pay the tax. However, if the trust could allocate this "phantom" income to the beneficiaries, they could pay the tax from their resources. In these circumstances, can the trust make an amount payable to the beneficiaries to accomplish this result? What if the accruing interest is never paid (i.e. the business fails) – can the beneficiaries claim a deduction for the interest included in income which was never received?

Note this problem could also arise where a trust held shares of a QSBC that "went public" and made the election under section 48.1 to crystallize the capital gain.

**CRA response:**

While a trust's income is determined in accordance with the provisions of the Income Act, the amount payable to the beneficiary is determined in accordance with the trust indenture. It is our understanding that so-called phantom income, such as that arising from the accrual of interest income, would not be defined as income for trust law purposes. Hence, at first glance, it is unlikely that such phantom income would be payable in the year to a beneficiary.

We dealt with a similar issue in a Round Table that was held on February 16, 1995 (document number 9503120), wherein we were asked to comment on distributions of deemed taxable capital gains that were triggered as a result of an election made according to subsection 110.6(19) of the Act. That provision was introduced in connection with the elimination of the $100,000 lifetime capital gains exemption and permitted certain personal trusts to elect to have a deemed disposition of capital property on February 22, 1994. The election would give rise to a deemed capital gain in the trust and a corresponding "bump" to the tax basis of the assets to the fair market value on that date. However, there remained the issue of whether the deemed gain could be made payable to the beneficiary in order for the gain to be designated in favor of the beneficiary under subsections 104(21) and 104(21.2) and thus enabling the beneficiary to claim the unused portion of his or her capital gains exemption.

In our response we stated that because a deemed taxable capital gain is a "nothing" under trust law, in order for it to be payable to any beneficiary the terms of the trust must first specifically give the trustees the discretion to pay out or make payable an amount equivalent to the deemed capital gain or the discretion to pay out or make payable amounts that are defined as income under the Act.

The same comments would be applicable to the situation described in this question where an amount is included in the computation of income according to subsection 12(4) of the Act but no property is received by the trust and it is not considered to have received income at law.

Where the trust has accrued and reported interest on a debt obligation and has at any particular time disposed of the obligation for consideration equal to its fair market value at the time of disposition, the trust may, by virtue of subsection 20(21) of the Act, deduct in computing income for the year of disposition the over accrued amount; that is the amount, if any, by which the aggregate of the amounts of interest on that debt obligation that were included in the trust's income for the year of disposition and all previous years exceeds the total interest actually received thereon. There is no provision to allocate the subsection 20(21) of the Act deduction to beneficiaries.

On the disposition of the investment contract, a capital loss could result if the proceeds of disposition are less than the adjusted cost base of the investment contract.

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**Topic 4 – Section 84.1 and a Structured Sale**

An operating corporation has three related shareholders – Father (personally), and two sons, each through a holding company. Father has implemented an estate freeze under which he converted his common shares (with ACB and PUC of $100) into $1 million of redeemable preferred shares, and the sons' holding companies subscribed for new common shares. Father now wants to implement a structured exit from the operating company and proposes the following series of transactions:

- Father and the sons will currently enter into a contract under which Father will agree to sell to each of them $100,000 of preferred shares on December 31, for five years commencing 2004 and ending 2008.
- The annual purchase price will be paid by a promissory note due 30 days after the purchase (ie. On January 30 2005 to 2009).
- Every January, each son will transfer the recently purchased preferred shares to his holding company using ss. 85(1) elections, taking back consideration consisting of a promissory note of $99,900 and preferred shares with a redemption amount of $100.
- Opco will redeem the preferred shares recently purchased by the sons' holding companies. These companies will be deemed to receive dividends of $99,999, but that dividend will be deductible under ss. 112(1). (Assume Opco does not generate any refundable dividend tax).
- The sons' holding companies will use the redemption proceeds to pay off the promissory notes issued to their respective shareholders.
- The sons will then apply those proceeds to pay the promissory notes issued to Father.

Confirm that section 84.1 does not apply.

**CRA Response:**

This scenario was considered in document 2003-0035435/14. In that document we indicated that it was our view that both section 84.1 and GAAR may apply to the above series of transactions. Our view remains unchanged.

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**Topic 5 - Trust Distributions**

A non-resident relative ("Uncle") of a Canadian resident taxpayer ("Niece") established a discretionary trust in an offshore jurisdiction several years ago. In addition, the mother of Niece (Mother) who is a resident of Canada has made contributions to the trust as well, but such contributions are insignificant in comparison to the contributions made by Uncle. The trust was established while Niece was a minor, living in a foreign country. However, Niece has since immigrated to Canada and is now resident here. The beneficiaries of the trust are Niece and her children (but not her spouse). One of the children ("Cecily") has since moved to the United States to study, and has indicated her plans to stay in the US to marry a US citizen.

The trustees of the trust are Uncle and another non-resident family friend. The trust property consists of a portfolio of investments, including shares in private and public Canadian corporations, Canadian and foreign real estate, and debt obligations of a number of governments.

Cecily has asked the trustees to distribute a portion of the trust assets to her so she can purchase a house in the United States. The trust has just sold a piece of Canadian real estate and has realized a capital gain of $300,000. The trustees are prepared to distribute the sale proceeds from this disposition to Cecily. The trustees have been advised that the trust is deemed to be resident in Canada by virtue of paragraph 94(1)(c), but that the trust may be able to avoid tax on the gain by allocating it to its beneficiaries under subsection 104(6).

A similar scenario was presented in technical interpretation 2003-002462117. In that particular case, the CRA concluded that no deduction would be allowed to the trust under subsection 104(6) in respect of the distribution of income to a non-resident beneficiary. Can you expand upon the rationale of this technical interpretation and explain whether the trust can claim a deduction under subsection 104(6) if it allocates the capital gain to Cecily? In particular, how would the introduction of proposed subparagraph 94(3)(a)(viii) affect your response?

**CRA Response:**

The Legislative Proposals in respect of Non-Resident Trusts and Foreign Investment Entities, most recently released by the Department of Finance in October 2003, propose to implement certain provisions of the budget tabled in Parliament on February 16, 1999 and significantly amend the rules relating to the taxation of trusts that are not otherwise considered resident in Canada. These proposals are expected to be effective for taxation years commencing after 2002. Consequently, we assume the question involves a taxation year commencing before 2003. We also assume that the trustees have discretion to distribute income and/or capital to any beneficiary in a particular taxation year and to simplify the example, that the only income of the trust is the taxable capital gain arising from the disposition of the Canadian real estate.

We will first assume that the trustees exercise their discretion to encroach on the capital of the trust to the extent of the taxable capital gain realized in favour of Cecily. In this scenario, the trust would not be entitled to a deduction under subsection 104(6) in respect of the amount so distributed to her because of the interaction of clause 94(1)(c)(i)(A) and subsection 104(7).

With respect to the computation of income under paragraph 94(1)(c), the relevant item here is clause 94(1)(c)(i)(A). That clause refers to "the amount, if any, that but for this subparagraph would be its taxable income earned in Canada for that year." Stated another way, the amount that would be the trust's taxable income earned in Canada if it were not resident in Canada for the year.

The taxable income earned in Canada would be computed under subsection 115(1). Paragraph 115(1)(b) specifically includes in income taxable capital gains from the disposition of taxable Canadian property other than treaty-protected property. A taxable capital gain from the disposition of Canadian real property would not be treaty-protected property (since all of Canada's treaties, including the income tax convention with the United States protect Canada's right to tax the gain on the disposition of Canadian real property). Hence, the taxable capital gain from the disposition of the Canadian real property would be included in income under paragraph 115(1)(b). While a non-resident trust computing its income under section 115 would be entitled to a deduction under subsection 104(6) to the same extent as any other trust computing its income under Part I, the amount of the deduction under subsection 104(6) is limited by subsection 104(7).

Subsection 104(7) limits the deduction otherwise available under subsection 104(6) in respect of income of the trust that is payable to a designated beneficiary unless the trust was resident in Canada throughout the taxation year. When Cecily ceased to be resident in Canada, she became a designated beneficiary for the purpose of subsection 210 and subsection 104(7). Since the portion of the trust's taxable income as computed under clause 94(1)(c)(i)(A) is computed as if the trust were not resident in Canada, subsection 104(7) limits the amount of any deduction available under subsection 104(6) in respect of the income described in clause 94(1)(c)(i)(A) that is payable to a designated beneficiary. Note that the deduction under subsection 94(3) for income payable to a beneficiary is limited to income described in clauses 94(1)(c)(i)(B) and 94(1)(c)(i)(C).

**Analysis based on the draft legislation released by the Department of Finance in October 2003**

Provided that the Legislative Proposals released by the Department of Finance in October 2003 are enacted in substantially the same form as currently proposed, the trust would be deemed resident for most purposes of the Act under subsection 94(3) for taxation years commencing after 2002 and would compute its income in the substantially the same manner as any other trust resident in Canada, subject to any exclusions found in subsection 94(4). In addition, under the Legislative Proposals, a trust's deduction under subsection 104(6) for distributions of income to a non-resident beneficiary would be limited by proposed subsection 104(7.01).

With respect to our example, the trust would presumably be deemed resident in Canada under proposed subsection 94(3) by reason of the Mother's contribution to the trust. As a result of the Mother's contribution, the trust would have both a resident contributor and a resident beneficiary. If the Mother had not made any contribution to the trust, the trust presumably would not have had a connected contributor as defined in subsection 94(1) and thus would not have had a resident beneficiary, notwithstanding that the Niece is a beneficiary and is resident in Canada. The fact that the Mother's contribution is insignificant in respect of the total contributions made to the trust may reduce her liability for the trust's taxes under proposed subsections 94(7) and (8), but the trust would still be subject to tax as a resident of Canada. Assuming that the trustee's exercised their discretion to make the income of the trust payable to Cecily, proposed subsection 104(7.01) would limit the trust's deduction under 104(6) as follows:

Assume that trust's sole source of income in the year was a taxable capital gain of $150,000 on the disposition of the Canadian real estate. As shown in the example in the Department of Finance Technical Notes to the Legislative Proposals, the limitation under subsection 104(7.01) would be as follows:

Because of subsection 104(7.01), the maximum deduction under subsection 104(6) would be reduced to nil (i.e., $150,000 minus the total of: 150,000 + ((.60 x 0) and (0.35 x 0))). Note that the trust is exempt from Part XII.2 tax and from having to collect a Part XIII tax in respect of the amounts made payable to Cecily because the trust is not treated by proposed subsection 94(3) as resident in Canada for these purposes. This is the intended result as the limitation imposed by subsection 104(7.01) is intended to approximate the Part XII.2 tax and Part XIII tax which would otherwise be imposed if the management and control of the trust was in Canada.

As the trust would not be entitled to a deduction under 104(6) for the income that is payable to Cecily, proposed subparagraph 94(3)(a)(viii) would not be applicable to the payment and thus, the trust would not be required to withhold Part XIII tax from the payment made to Cecily. However, if proposed subsection 104(7.01) does not reduce the trust's deduction under subsection 104(6) in respect of such income or if the trust makes any other type of payment, such as a payment of interest, to a non-resident person that would be subject to Part XIII if the trust were deemed resident in Canada for the purpose of that payment, proposed subparagraph 94(3)(a)(viii) will deem the trust to be resident for the purpose of that payment and the trust will be required to withhold the appropriate amount of Part XIII tax from that payment.

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**Topic 6 – Life Insurance Proceeds Received by a Partnership**

**Question 1**

The CRA has considered, in document No. 9129745, the tax treatment of life insurance proceeds received by a partnership wherein the partners were individual professionals. Does this document still reflect the views of the CRA?

**CRA Response:**

The comments in this document are still relevant for life insurance proceeds received by a partnership composed of individual members. We have also discussed this issue in Interpretation Bulletin IT-430R3 (Consolidated) *Life Insurance Proceeds Received by a Private Corporation or a Partnership as a Consequence of Death* dated December 2, 2002.

**Question 2**

Please consider the following hypothetical situation involving a partnership with corporate partners:

Three arm's length doctors (X, Y and Z) created a medical partnership many years ago. It operated as a general partnership of individuals for many years. Recently, each doctor incorporated professional corporation (Xco, Yco and Zco) and rolled his respective partnership interest into the professional corporation.

About the same time, the doctors determined that they should obtain life insurance to fund the liquidity provisions of their partnership agreement. In this regard, insurance was purchased, although the premiums have not been deducted for income tax purposes. The life-insurance policies are exempt policies under section 148 of the *Income Tax Act* (the "Act") and section 306 of the *Income Tax Regulations*, and, accordingly, a payment under the policies, in consequence of the death of any person whose life was insured will not be taxable.
The fair market value of the partnership interest is derived primarily from personal goodwill, which disappears on the death of the principal shareholder of the corporate partner, and reduces the value of the partnership by about one-third.
Please comment on the tax consequences for each of the following alternative scenarios with respect to the payment of the life insurance proceeds on the death of one of the principal shareholders.

**Scenario A**

The beneficiary of the insurance is the partnership. Under the terms of the partnership agreement, Xco, Yco and Zco have agreed that after the death of one of the principals/shareholders (the "deceased") of the corporations, each of the two remaining corporate partners would receive 50% of the total payout. Under the terms of the partnership agreement, they would use all the proceeds from the insurance to purchase the 1/3 interest held by the deceased's corporation.

How would the receipt of the insurance proceeds affect the ACB of the remaining corporate partners?

Would the deceased realize proceeds of disposition for his interest equal the insurance proceeds?

**CRA Response:**

(a) If the terms of the partnership agreement provide that the life insurance proceeds are to be paid to a particular corporate partner, subparagraph 53(1)(e)(iii) of the Act would bump that partner's ACB by the insurance proceeds allocated to the partner by the partnership. Where an amount to which subparagraph 53(1)(e)(iii) of the Act applies, is received by a partnership and allocated to a partner that is a private corporation, the corporation may add the amount so allocated to its capital dividend account, at the time the partnership received the proceeds.

Paragraph 53(2)(c)(v) of the Act would apply to reduce the ACB of the particular corporate partner's interest when the life insurance proceeds are paid to it from the partnership.

(b) Although the insurance proceeds were occasioned by the death of an individual, there is no deemed disposition of a partnership interest on death pursuant to subsection 70(5) of the Act, as all the partners are corporations. In the case of corporate partners, they do not cease to exist on the death of a shareholder.

However, a disposition will occur, where the partnership agreement provides for the disposition of the partnership interest of the deceased's corporation. The proceeds of disposition would generally be determined by the terms of the partnership agreement, and would normally be equal to the fair market value of the partnership interest.

**Scenario B**

The beneficiary of the insurance is the partnership. Pursuant to the terms of the partnership agreement, the deceased's corporation would receive all the insurance proceeds. The deceased's corporation would then, under the terms of the partnership agreement, surrender its 1/3 interest in the partnership for an amount equal to its capital account balance, which is the fair market value of the partnership interest.

In these circumstances:

(a) How would the calculation of the ACB of the deceased's corporation's partnership interest be calculated?

(b) Would the deceased's corporation be considered to have disposed of its partnership interest for proceeds equal to the capital account?

(c) Would section 69 apply?

**CRA Response:**

(a) In this situation, our response would be the same as in Scenario A. Subparagraph 53(1)(e)(iii) of the Act would bump the corporate partner's ACB by the insurance proceeds allocated to the partner by the partnership. Paragraph 53(2)(c)(v) of the Act would reduce the ACB of the corporate partner's interest when the life insurance proceeds are paid to it from the partnership.

(b) In the situation outlined above, the deceased's corporation would likely be considered to have disposed of its partnership interest for proceeds equal to the balance in its capital account since this represents the fair market value of the partnership interest.

(c) Since the corporate partners are dealing at arm's length with each other, section 69 of the Act would not apply. However, the determination of whether the corporate partners are dealing at arm's length is a question of fact.

**Scenario C**

The proceeds of the insurance go directly to the corporate partner, rather than through the partnership. The deceased's corporation would then surrender its interest for an amount equal to its capital account, which is the FMV of its partnership interest.

(a) Would the corporate partner receive the insurance proceeds tax-free?

(b) Would the deceased's corporation be considered to have disposed of its partnership interest, and for what amount?

**CRA Response:**

(a) The corporate partner would receive the life insurance proceeds on a tax-free basis, and would be able to add the proceeds to its capital dividend account.

However, if the corporate partner is not the beneficiary of the life insurance policy, and the life insurance proceeds are instead paid directly to the deceased's estate, then the corporation would not be entitled to add the insurance proceeds to its capital dividend account. The estate would, however, receive the life insurance proceeds tax-free.

(b) Given the facts outlined above, and provided that the partnership agreement covers the disposition of the partnership interest held by the deceased's corporation, then that corporate partner would be considered to have disposed of its partnership interest for proceeds equal to the balance in its partnership capital account since this is equal to the fair market value of the partnership interest.

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**Topic 7 - Immigration of a Discretionary Trust**

A non-resident discretionary trust is deemed resident under paragraph 94(1)(c) for its 2001 taxation year. The trust became a factual resident in 2002 when all non-resident trustees were replaced with Canadian trustees. Since the trust was already deemed resident in Canada in 2001, could it “become” a resident in 2002 under section 128.1?

**CRA Response:**

The CRA’s position with respect to the application of subsection 128.1(1) of the Act in such a situation has been stated in document 2003-0013445. In this technical interpretation, we confirmed that subsection 94(1) of the Act applies where at any time a person described in either of subparagraphs 94(1)(a)(i), (ii) or (iii) of the Act was beneficially interested in a trust that was a non-resident of Canada throughout its taxation year. It follows that subsection 94(1) of the Act does not apply in respect of the taxation year of a trust after it has become a resident of Canada. In our view, such a result is in line with the object of the Act in allowing the application of the more specific rules found in section 128.1 of the Act when there has been a change of residence during a taxation year.

In the situation outlined in your question, subsection 94(1) of the Act would therefore be inapplicable with respect to the 2002 taxation year of the trust since it would not have been a non-resident of Canada throughout the said taxation year. As a result of the trust becoming a factual resident of Canada during its 2002 taxation year, subsection 128.1(1) of the Act would find application, thereby deeming the trust’s 2002 taxation year to have ended immediately before the particular time it became resident in Canada and a new taxation year would be deemed to have begun at that particular time. Since the trust will have been a non-resident throughout its taxation year deemed to have ended immediately before it became resident in Canada, subsection 94(1) of the Act will apply in respect of this short taxation year. As a result, the trust will be deemed to be resident in Canada throughout the said short taxation year.

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**Topic 9 - Partnership Estate Freezes**

**Question 1**

Does CRA have any doubts or concerns about the possibility of using partnerships in estate freezes?

**CRA Response:**

In order to provide any specific comments, we would need to review the proposed transactions whereby a partnership is used to freeze an estate. We have never issued a favourable advance income tax ruling on proposed transactions involving the use of a partnership to implement an estate freeze.

We considered this issue at the 1992 Canadian Tax Foundation Round Table. In response to question 13 at that conference, we stated, in part, that whether or not a partnership is used for estate-freezing purposes, the allocation of income within a partnership should recognize the capital contributions of the partners, as well as the non-monetary contributions of each partner. Otherwise, subsection 103(1) or (1.1) of the Act may apply to alter the allocation of partnership income, loss or other amounts. We continue to hold this view.

**Question 2**

How can such concerns be addressed in practice?

**CRA Response:**

Whether subsection 103(1) or (1.1) would apply in any particular situation would depend on the specific facts involved. However, our overall position is that these provisions would apply.

In order to provide any definitive comments on a particular arrangement whereby a partnership is used in an estate freeze, and on whether subsections 103(1) or 103(1.1) would apply, we would need to review all of the facts and documentation related to the transactions. Such a review would normally only be undertaken in the context of an advance income tax ruling request.