2005 STEP National Conference
Practitioner / CRA Round Table
June 7, 2005

2005 STEP Round Table
Q1. Section 84.1

A taxpayer holds shares of Opco (the "Opco shares") at the time of death. The lifetime capital gains deduction is claimed in computing the taxable income on the taxpayer's terminal return.

Under paragraph 70(5)(b), the taxpayer's estate (the "Estate") is deemed to have acquired the Opco shares at their fair market value immediately before the taxpayer's death. However, for the purposes of section 84.1, subparagraph 84.1(2)(a.1)(ii) appears to require a reduction in the ACB of those shares by the amount of the capital gains deduction claimed in the terminal return.

For the purposes of section 84.1, would the Estate's ACB of the Opco shares be reduced by the amount of a capital gain deduction previously claimed by the taxpayer in the case of a sale by the Estate in the following circumstances?

a) The Opco shares are sold for cash to an individual who was not related to either Opco or the taxpayer before he passed away ("Stranger").
b) The Opco shares are sold for cash to a corporation controlled by the Stranger ("Strangerco").
c) The Opco shares are sold for cash to children of the deceased who are beneficiaries of the Estate.
d) The Opco shares are sold for cash to a corporation controlled by children referred to in (c) ("Childco").

Does the transmission of the Opco shares from the deceased to the Estate constitute a "transaction or event between persons not dealing at arm's length" for the purposes of paragraph 84.1(2.01)(c)?

Response:

As indicated in the answer to Question 33 of the CTF 1992 Round Table, the transmission of shares of a taxpayer to the taxpayer's estate constitutes a transaction or event between persons not dealing at arm's length. That conclusion is based on the case of *Estate of Karma May* v *MNR* (88 DTC 1189). Therefore, paragraph 84.1(2)(a.1) applies to reduce the adjusted cost basis of the Opco shares held by the Estate for the purposes of section 84.1 by the amount in respect of which a deduction under section 110.6 was claimed by the taxpayer.

However, section 84.1 can only apply where shares of a corporation are disposed of by a taxpayer to another corporation with which the taxpayer does not deal at arm’s length. Therefore, the provision could only apply to scenarios b) and d).

If Stranger is a beneficiary of the Estate (which may be the case, if Stranger is a close friend of the deceased), Stranger and Strangerco will be deemed not to deal at arm’s length with the Estate as a result of the application of paragraph 84.1(2)(d). Provided the other requirements of section 84.1 are satisfied, it will apply to the transaction and the ACB of the Opco shares is adjusted for the purposes of that section by paragraph 84.1(2)(a.1). The same reasoning applies to the transfer of the Opco shares to Childco.

2005 STEP Round Table
Q2. Association Rules

For the purposes of the association rules, beneficiaries of a discretionary trust are deemed to own all the shares of a corporation held by the trust (see generally, paragraph 256(1.2)(f)). Where the trust allows for the addition of beneficiaries, subsection 248(25) will apply to deem persons who have contributed property to the trust or who deal at arm's length with any such person to be beneficiaries of the trust. Where the trust is governed by common law, are these persons considered to be beneficiaries for purposes of the association rules? Are these persons considered to be beneficiaries for purposes of subsection 75(2)?

Response:

The statement in the question is not completely accurate as the definition subsection 248(25) determines who is beneficially interested in a trust, not who is a beneficiary for the purposes of section 256. Furthermore, that provision only deems a person who has contributed property to the trust or who does not deal at arm's length with any such person to be beneficially interested in a trust to the extent that such person might become beneficially interested in the trust because of the exercise of any discretion.

As we indicated in our answer to question 21 at the 2004 APFF Round Table, the definition of "beneficiary" provided in subsection 108(1) applies only for the purposes of subdivision k of Division B of Part I of the Act. Therefore, this definition does not apply for the purposes of paragraph 256(1.2)(f). Further, subsection 248(25) does not apply for the purposes of paragraph 256(1.2)(f) because the expression "beneficially interested" is not used therein.

That being said, the meaning of the phrase in the question "where the trust allows for the addition of beneficiaries" is unclear. It could be referring to a situation where the terms of the discretionary trust deed provide that the interests in the trust are "to A for life and then to B absolutely." Some may informally describe this scenario as one where A is the beneficiary and the terms of the trust allow for the addition of a beneficiary - B. In actuality, both A and B are beneficiaries of the trust at law. Thus, in this scenario, B would be deemed to own shares pursuant to paragraph 256(1.2)(f) as B's share of the trust's capital depends on the trustee's (or trustees') exercise or failure to exercise any discretionary power in relation to A.

As far as subsection 75(2) goes, that provision does not make reference to a beneficiary but to any "person" who transferred property to a trust directly or indirectly. Consequently, that provision would apply if, for example, the property (or substituted property) may revert to that person.

2005 STEP Conference
Q3. Subsection 129(1.2)

Section 129 entitles a corporation to receive an amount from the Minister in respect of its “refundable dividend tax on hand” account. The amount that it can receive in a given taxation year cannot exceed 1/3 of all the taxable dividends that it pays on its shares in that year. Subsection 129(1.2) excludes from the computation of that maximum amount dividends paid on a share acquired in a transaction or a series of transactions one of the main purposes of which is to enable the corporation to obtain the dividend refund. Much of post mortem estate planning is devoted to obtaining relief from double taxation. One method includes liquidating a corporation and obtaining a refund under section 129 to the extent of 1/3 of the deemed dividend resulting from the application of subsection 84(2) to the wind up. Would you comment as to the circumstances under which subsection 129(1.2) might be applied in post mortem estate planning?

Response:
Subsection 129(1.2) is a broadly worded anti-avoidance provision. Whether or not “one of the main purposes” is to enable a corporation to obtain a dividend refund such that subsection 129(2.1) will apply to the particular dividend is a question of fact. We have not adopted any administrative position or otherwise set guidelines with regards to situations to which the provision might apply.

We have ruled favorably on the non-application of subsection 129(1.2) in situations involving estates and reorganizations of shares acquired by the estate where the redemption amount of the shares is tied to the RDTOH of the corporation and thus enables the corporation to recover its RDTOH. The most recent example is as set out in document 2004-008855. In that file, the estate held all of the “equity” shares of the corporation prior to such shares being exchanged for shares of what became Amalco. Since the estate held all of corporation’s equity prior to the acquisition of the shares of Amalco and this continued to be the case afterwards, we determined that the fact that the shares were designed to permit an efficient recovery of Amalco's dividend refund should not, by itself, cause subsection 129(1.2) to apply. In the context of those particular circumstances, there was no shift in the shareholdings of a corporation that were designed to put dividend income in the hands of a tax-exempt person, while at the same time allowing the corporation to collect a dividend refund. As part of our analysis, we considered the Technical Notes to subsection 129(1.2) which make it clear that it “is designed to prevent a private corporation from structuring arrangements in order to obtain a dividend refund without the related shareholder tax being paid” and that the rule “is not intended to interfere with the normal operation of subsection 129(1) as part of the system for integrating the taxes paid on investment income by a private corporation and the taxes paid by the shareholders on the subsequent distribution of that income.”

We caution, however, that whether one of the main purposes for acquiring the shares on which a dividend is paid is to enable the corporation to obtain a dividend refund is a question of fact that has to be determined in light of all the relevant facts. As indicated in the answer to question 10 of the 2002 APFF Round Table, subsection 129(1.2) could technically apply even if the shareholders pay tax on the dividend.

2005 STEP Round Table
Q4. Compliance Problems in Trust Reporting

It is becoming increasingly common for inter vivos trusts to have investments in mutual funds. Because mutual funds are required to report for tax purposes within ninety days of the end of the calendar year, the same date that an inter vivos trust must file its tax return, it is becoming harder and harder for inter vivos trusts to obtain all of the required information for completion of their tax return on time. What advice would you give in circumstances where an inter vivos trust does not have access to all of the necessary information by the due date for filing its return, because this information is being furnished by a person which has the same reporting deadline?

Response:

As outlined in the T3 Guide (page 12 of the 2004 Guide), where the preparer of a trust return does not have the information slips needed to complete the return when it is due, the income should be estimated. Once the actual slips are received, if your estimate differs from the actual amounts, the slips, accompanied by a letter requesting an adjustment to the trust's income should be sent to us. This is important to avoid any late filing penalties.

Currently, the Agency is not considering having two distinct filing deadlines for inter vivos mutual fund trusts versus non-mutual fund trusts. The same reporting problems would occur where a non-mutual fund trust holds any interest in a trust. We understand the Investment Dealers Association has written the Department of Finance requesting an amendment to require Income Trusts and Limited Partnerships to report their distribution breakdowns for tax purposes by February 28.

2005 STEP Round Table
Q5. Employee Ownership - Trust as Market Maker

One of the problems in employee-owned small businesses is the lack of liquidity when a shareholder ceases to be an employee. A departing employee would rather realize a capital gain on a sale of shares than a deemed dividend on a redemption of the shares of employer-corporation. In many cases, the employer-corporation creates a “market maker” (“Buyco”) to buy the employees’ shares so departing employees are able to claim the lifetime capital gains exemption.

From a corporate law standpoint, the employer-corporation should not be a shareholder of Buyco as the resulting cross-ownership would be contrary to the “corporate incest” rules contained in the various Business Corporations Acts. However, the employer-corporation will want to control Buyco. The solution is to create a trust which would then incorporate Buyco.

The settlor of the trust will be a senior officer of the employer-corporation. The settlor will create the trust with a deed of gift, the original trust property being a $10 bill or other non-income producing property. The trustees will be senior officers of the employer-corporation. The employer-corporation will be the sole beneficiary of the trust.

The trust will borrow nominal funds from the employer-corporation to subscribe for shares of Buyco. When Buyco is required to purchase shares from employees, it will borrow the necessary funds from the employer-corporation, pledging the purchased shares as security for the loan. This loan will be repaid when shares are resold by Buyco to other employees, or may be repaid by Buyco’s delivery of the shares for cancellation.

Over time, it is expected that Buyco will accumulate more employer-corporation shares than it resells. As a result, it will not have sufficient cash to repay its loans from the employer-corporation. Rather than triggering a deemed dividend to Buyco on the delivery of the employer-corporation shares to employer-corporation (effectively a redemption or repurchase) in satisfaction of the debt, the trustees would distribute the Buyco shares to the employer-corporation in satisfaction of the employer-corporation’s capital interest in the trust. Buyco would then become a wholly owned subsidiary of employer-corporation, and a vertical amalgamation would take place.

To avoid the tax that would be payable by the trust on any increase in the value of the Buyco shares during the period of the trust’s ownership of such shares, the trust would like to rely on subsection 107(2) in respect of the distribution of the Buyco shares to the employer-corporation. If the trust is a “prescribed trust”, subsection 107(2) will deem the trust to have received proceeds equal to its cost of the Buyco shares.

Regulation 4800.1 defines a “prescribed trust” to be a trust “maintained primarily for the benefit of employees of a corporation ... where one of the main purposes of the trust is to hold interests in shares of the capital stock of the corporation....”

One of the main purposes of the trust in this structure is to acquire shares of the employer-corporation from employees, so the latter test will be met. With respect to the “primarily for the benefit of employees” test, the trust will exist only so employees can get the benefit of capital gains treatment on disposition of their shares, rather than deemed dividend treatment.

In such circumstances, would the trust constitute a “prescribed trust” for the purposes of Regulation 4800.1?

Response:

While an arrangement such as this has many tax issues to be considered, my response will focus only on the question asked.

A determination as to whether a trust is a prescribed trust as defined in paragraph 4800.1(a) of the Regulations in a particular situation requires a number of factual determinations.

However, based solely on the information provided in the question, it is difficult to see how the trust could be seen to have been established for the benefit of the employees if the employees are not the beneficiaries of the trust. To the extent that the only benefit that the employees are expected to derive from the trust is the tax benefit, as defined in subsection 245(1), from being able to structure their affairs to realize a capital gain rather than a deemed dividend on the disposition of their shares, it is our view that the conditions in section 4800.1 of the Regulations would not be met and the trust would not be a prescribed trust.

Just as we would not consider a tax benefit in and by itself to be a benefit that would be included in the employee’s income under subsection 105(1), the reference to a benefit for the employees of a corporation in section 4800.1 of the Regulations would not appear to include a tax benefit. However, as we have previously not considered the matter in the context of an advance income tax ruling, we would be prepared to consider further representation on this issue in the context of a ruling as to why such a benefit should be considered to be a benefit for the purposes of section 4800.1 of the Regulations. We would expect such representation to address the issue of why, if a tax benefit were to be considered a benefit for the employees, it should not also be considered to be a benefit for the purpose of subsection 105(1) as well. The procedures for obtaining an advance income tax ruling are set out in Information Circular 70-6R5.

2005 STEP Round Table
Q6. Application of subsection 164(6)

Subsection 164(6) allows for a carryback of a capital loss where the taxpayer's legal representative makes an election within the first year of the estate. If a taxpayer dies intestate, or alternatively, if the taxpayer leaves all of the property of his estate outright to specific beneficiaries, is an estate created for purposes of subsection 164(6)? Does one need to be concerned about whether there is, in fact, an estate before this provision can be used?

Response:

In general, subsection 164(6) provides that where, in the course of administering the estate of a deceased taxpayer, the taxpayer's legal representative has, within the first taxation year of the estate, disposed of capital property of the estate, among other things, and as a result of the disposition(s), the total amount of any capital losses exceeds the total amount of any capital gains, the legal representative may elect, in prescribed form, to deem the capital losses to be capital losses of the deceased taxpayer in the deceased's final taxation year and not capital losses of the estate.

The Act does not provide any definition of an estate, however subsection 104(1) provides that for the purposes of the Act, unless the context otherwise requires, "a trust shall be read as a reference to the trustee, executor, administrator, liquidator of a succession, heir or other legal representative having ownership or control of the trust property."

Generally, property of the deceased passes to the personal representative of his or her estate, whether the deceased died testate or intestate or whether the property is left outright to specific beneficiaries. However, some property may not pass to the personal representative. For example, if the property is held in joint tenancy, on the death of the first joint tenant, the property does not form part of the deceased's probate estate and at law, the surviving joint tenant would now hold the whole interest in the property. While subsection 70(5) would be applicable immediately before the death of the deceased, the personal representative, in this instance, would not be disposing of property to an heir.

In the case of specific bequests, the T3 Guide explains that a return may not have to be filed if the estate is distributed immediately after the person dies, or if the estate did not earn income before the distribution. As the property would generally be transferred on a rollover basis to the beneficiary under subsection 107(2), subsection 164(6) would not appear to be relevant. However, if the conditions specified in subsection 107(2.001) are met, the personal representative may file an election that subsection 107(2) not apply and any gain or loss would be recognized by the estate at that time. Subject to various "stoploss" rules in the Act, any resulting loss may then be the subject of a subsection 164(6) election.

2005 STEP Round Table
Q7. Tax Instalments

Is it departmental practice that an inter vivos trust does not have to pay tax instalments? Absent a specific provision to the contrary, it seems that subsection 156(1) would apply to require an inter vivos trust to pay tax instalments, although this does not seem to be commonly done.

Response:

Subsection 156 requires an individual to make instalment payments if certain conditions are met. As trusts are taxed as individuals, generally, they are subject to these instalment payment provisions. For example, an inter vivos trust, including a mutual fund trust, may be required to make quarterly instalments during the year on account of its Part I tax payable for the year. However, a testamentary trust, instead of making instalment payments, is allowed to pay its tax payable for the year within 90 days from the end of the taxation year by virtue of paragraph 104(23)(e).

2005 STEP Round Table
Q 8. Obligation to File Tax Returns

Subsection 150(1) deals with the requirement to file income tax returns. For trusts and estates, a tax return must be filed within 90 days of the end of the year. However, subsection 150(1.1) applies to override this requirement, and states that an individual (presumably including a trust) does not need to file a tax return unless certain conditions are met, such as tax is payable by the individual, the individual, if a resident of Canada, had a taxable capital gain or disposed of capital property in the year, or where the individual is non-resident throughout the year, the individual had a taxable capital gain or disposed of taxable Canadian property. Where subsection 75(2) applies, a trust may not have tax payable, on the basis that its income has been attributed to another person. In addition, where the trust distributes its income to a beneficiary, the same may apply. In such circumstances, it seems that a tax return would not be required for the trust, unless it is demanded pursuant to subsection 150(2). Does CRA agree with this?

Response:

No. As stated on page 10 of T4013, *2004 T3 Trust Guide*, a T3 return is generally required for each year in which the trust allocates income to any of the beneficiaries, makes benefits available to the beneficiaries or holds property that is subject to subsection 75(2).

A *T3 Trust Income Tax and Information Return* is both a return of income as described in paragraph 150(1)(c) of the Act and an information return as described in subsection 204(1) of the Regulations. Thus, although subsection 150(1.1) of the Act may relieve a trustee from the statutory obligation of filing an income tax return in some circumstances, the trustee is still required by law under subsection 204(1) of the Regulations to file an information return in prescribed form for each year in which the trustee has control of or receives income, gains or profits in his or her fiduciary capacity. If none of the conditions listed under *Who Should File* on page 10 of the T3 Guide apply to a trust for a particular year, the CRA will waive the requirement to file the form prescribed for subsection 204(1) of the Regulations, the *T3 Trust Income Tax and Information Return*. A T3 return is required, however, when the beneficiaries, or in certain cases the settlor, is required to include an amount in his or her income. Also, as stated on page 34 of the T3 Guide, a T3 information slip is used to communicate to the settlor or other contributor to the trust and the CRA, the amount of income that is to be included in the contributor's income rather than in the income of the trust or other beneficiaries.

In addition, it should be noted that many of the designations and elections available to a trust are only valid if the designation is made in the trust's return of income for the taxation year. This would necessitate the filing of a T3 return.

2005 STEP Round Table
Q9. Part Year Residence of a Trust

Is it possible for a trust to be a part year resident of Canada under the Income Tax Act?

Response:

No. While a trust is deemed (in respect of the trust property) to be an individual for the purposes of the Act such that it seems like section 114 might apply to make it a part year resident, the fact that either paragraph 128.1(1)(a) or 128.1(4)(a) will apply when a trust either becomes resident in Canada or ceases to be resident Canada ensures that, for any taxation year in which the trust is resident in Canada, it will be resident in Canada throughout that taxation year. The effect of paragraphs 128.1(1)(a) and 128.1(4)(a) is to create two short taxation years for the trust within the same calendar year; one in which the trust is resident in Canada and one in which it is not resident in Canada. As stated in paragraph 27 of Interpretation Bulletin IT-262R2, *Losses of Non-Residents and Part-Year Residents*, the application of paragraphs 128.1(1)(a) and 128.1(4)(a) to a trust that has become resident in Canada or ceased to be resident in Canada ensures that a trust will not have a taxation year in which its taxable income is computed under section 114 (i.e., a taxation year in which the trust is resident in Canada for part of the year and non-resident for the other part).

2005 STEP Round Table
Q10. Residence

Subsection 250(5) deems a person to be a non-resident where under an international tax treaty they are considered resident in another country, and they would otherwise be resident in Canada "for purposes of this Act". What is your interpretation of the phrase "for purposes of this Act"? Does it mean that the person must be resident for all purposes of the Act, or simply for a number of purposes?

Response:

This question has been raised in the context of the proposed non-resident trust rules. In particular, where subsection 94(3) applies to deem a trust to be resident in Canada for the purposes of the application of several, but not all, provisions of the Act. In this regard, we do not believe that the phrase "for the purposes of this Act" in subsection 250(5) must be read as "for all purposes of this Act" [see documents 2001-0074395 and 2002-018035].

As part of our deliberations on this issue, we considered, in addition to the reasons behind the introduction of the proposed non-resident trust rules, the reasons behind the1999 amendment to subsection 250(5). As set out in the Supplementary Information to the February 24, 1998 Federal Budget, the amendment was to ensure that Canada's domestic rules for taxation and its obligations under its various tax conventions could not applied in a contradictory manner. Subsection 250(5) was amended to ensure that when a person is considered a resident of another country for purposes of a particular tax treaty that country has with Canada, the person is similarly treated for the purposes of the Income Tax Act. Thus, in our view, the fact that there may be some purposes of the Act for which the person is not otherwise considered resident in Canada would not preclude the application of subsection 250(5) to those provisions for which the person is considered to be resident in Canada. In other words, instead of focusing on which purpose or how many purposes the person is deemed resident, we have instead focused on whether a particular tax treaty or convention would apply to override those purposes.

2005 STEP Round Table
Q11. Compliance Assistance

Taxpayers and professional advisers are becoming increasingly concerned about the level of complexity in the rules applicable to international transactions. For example, the proposed amendments to the FAPI rules and foreign investment entities are highly complex and difficult to understand.

If these rules are passed into law, how will CRA assist taxpayers and their professional advisers in attempting to comply with them? Will guidance on these rules, such as forms and instructions, interpretation bulletins, or other authoritative commentaries be provided? Will CRA honor the due diligence defense and fairness relief be available for taxpayers and their advisers who try to comply but who have differences of opinion on the application of these rules?

Response:

First, I would like to say that the CRA welcomes the opportunity to address audiences in conferences and seminars like the one today. Your concerns and questions crystallize the early guidance that can be provided by us in anticipation of more formal guidance.

The CRA has been successfully assisting taxpayers and professional advisors in complying with very complex legislation in the past and this is no exception. We will continue to do so through our existing communication and service infrastructures. Where necessary, we will publish interpretation bulletins, forms and instructions etc. The CRA has always administered complex legislation such as these in a fair and responsible manner taking into consideration all facts in a case.

The proposed legislation on the taxation of non-resident trusts and foreign investment entities provides for a number of elections. We have created a draft of eight of these, the only eight for which we propose to create new forms. The taxpayer may make the other elections by including a letter notifying us of the election in the relevant return of income. We have structured the draft elections in such a way as to lead the taxpayer, step-by-step through the process, to make it as simple as possible to understand and comply with the new rules. Therefore, at the moment, it is not our intention to issue any information circulars, bulletins or guides when the legislation is passed, because of the way we've designed the election forms - each one is like a mini guide, filled with relevant definitions and guidance at each step of the form. After the draft forms have gone through our internal review process we intend to release them in Draft form to selected practitioners for consultation. At this time, we do not have any timeframes for when this consultation would take place.

With respect to the proposed legislation relating to the foreign affiliate and FAPI provisions, we understand that the Department of Finance is still considering substantive changes. We will provide further comment and guidance after revised proposals are released.

We are always open to opportunities to engage in a consultative process with our stakeholders where appropriate.

2005 STEP Round Table
Q12. Compliance with Proposes NRT/FIE Rules

The draft amendments on foreign investment entities were to apply from January 1, 2003 onwards. However, they have not been passed into law, and further changes are expected. In this period of uncertainty, what advice can you give taxpayers who are trying to comply with the rules for reporting foreign income from investment sources?

Response:

The proposed amendments, if passed, will be effective for taxation years beginning after 2002. The Department of Finance has indicated that they are not prepared at this time to recommend a change to the proposed general application dates for the non-resident trust and foreign investment entity proposals. We understand that this has caused uncertainty for taxpayers with regards to how to file. To date, CRA has not issued any formal guidance on how to file - it is difficult to issue formal guidance on proposed legislation that has not yet even been introduced in the House of Commons.

Basically, taxpayers have a choice of either declaring the income under the existing legislation or under the proposed legislation, and filing an amended return when the proposed legislation becomes law. The Department of Finance is responsible for commenting on any possible recommendations or changes that may be made to the proposed legislation. At the end of the day, taxpayers filing in accordance with the current (existing) rules, or the current version of the proposed rules, may have to file amended returns when the legislation passes.

The failure to accrue income as required by these proposed amendments will trigger interest charges on the overdue tax payments. Section 221.1 of the Income Tax Act allows interest to be charged on overdue taxes due to retroactive application of the rules. Senior management is currently reviewing a recommendation to waive the interest and late filing penalties related to the FIE/NRT income under the proposed rules. We will be in a better position to respond to this question when the legislation is introduced (in the House of Commons).

The Department of Finance continues to recommend to Parliament that a Bill implementing the proposals be tabled at the earliest opportunity.