2006 STEP Canada National Conference
Practitioner / CRA Round Table
June 13, 2006

2006 STEP Round Table
Q1. Requirement for Financial Statements

Can you give an update on any changes which are being proposed to the way T3's are assessed? In particular, there has been some discussion about whether financial statements for trusts will be required in the future. What is the current thinking on this matter?

Response

In her report of November 2005, the Auditor-General of Canada suggested that the CRA does not have enough information to adequately assess the tax at risk for trust returns. She identified possible areas of non-compliance relating to the allocation of income to beneficiaries and the 21-year deemed disposition rule. As a result, the Auditor-General recommended that trusts be required to file a statement of assets and liabilities with the trust's income tax return to allow the CRA to better assess the tax at risk in a trust return and focus its audit efforts to those returns most at risk. In addition, she recommended that the CRA:

- systematically evaluate the tax at risk in determining which trust returns to select for audit;
- capture and compile information related to the initial corrections made to the returns as filed in order to assist in the management of assessing activities related to trusts;
- complete an examination of the amounts recorded in our databases relating to the income allocated to beneficiaries to determine the tax revenue implications, if any, of the initial discrepancy identified by the Auditor-General in this area; and
- create a new compliance program to ensure that the income allocated to beneficiaries is reported on a T3 slip and that the beneficiaries include such amounts in their income.

In response, the CRA has initiated a study to identify the nature and extent of compliance issues related specifically to trusts. We are also currently reviewing our approach to verifying the information reported on a trust return as well as the feasibility of requiring trusts to file a statement of assets and liabilities with the return. The Auditor-General expressed the view that such a requirement should not be onerous on the trustee since the trustee is already required to report such information to the beneficiaries of the trust as part of the trustee's stewardship of the trust's assets. The study is still underway.

2006 STEP Round Table
Q2. Life Insurance Policies held by a Testamentary Trust

If a testamentary trust is obligated to fund a life insurance policy on the life of the surviving spouse and the trust is the beneficiary of the policy, would this taint the trust and preclude its being a spousal trust pursuant to subsection 70(6) of the Act? If trust income was used to pay the premium, would this cause the trust to fall offside? If trust capital was used to pay the premium, would this cause the trust to fall offside?

Response

For purposes of our reply we have assumed that the insurance policy is not an annuity or segregated fund contract and that the policy provides only benefits in respect of pure life insurance (i.e., benefits arising only on the death of the life insured) such that no part of the policy premium payments relates to any benefit other than pure life insurance protection.

We have limited our analysis to the application of subparagraph 70(6)(b)(ii) of the Act.

In order for property to be transferred on a tax-deferred (“rollover”) basis from a deceased taxpayer to a trust, subparagraph 70(6)(b)(ii) of the Act requires that the trust be one under which no person except the surviving spouse or common-law partner (“survivor”) of the taxpayer may, before survivor’s death, receive or otherwise obtain the use of any of the income or capital of the trust. Our position is that the mere possibility of a person other than the survivor receiving or obtaining, before the survivor’s death, use of the trust capital or income is sufficient to disqualify the property transfer from the rollover.

A duty to fund a life insurance policy out of trust capital or trust income would, in our view, be one under which a person may obtain the use of the trust capital or trust income. This is because the premium payment is assumed to maintain, for the period covered by the premium, the rights to receive insurance proceeds. Therefore, the existence of such a duty would be relevant in determining whether a rollover of property can occur to the trust under paragraph 70(6)(b) of the Act.

In the circumstances contemplated by your question, it would appear that persons other than the survivor may, during the survivor’s lifetime and as a result of the duty to pay insurance premiums out of trust property, obtain the use of the trust income or capital. Therefore, we are of the view that the trust would not satisfy the conditions of subparagraph 70(6)(b)(ii) of the Act.

As a final comment, whether the trust is one that seeks to satisfy the requirements of paragraph 70(6)(b) of the Act or not, and whether the duty is to pay the premium out of trust income or trust capital, it would appear that the policy beneficiary would have a benefit, from the trust’s payment of the policy premium, resulting in the application of section 105 of the Act.

2006 STEP Round Table
Q3. Obligation to File Tax Returns

At last year's STEP conference, we addressed the issue of whether a trust that only held property that was subject to subsection 75(2) of the Act was required to file a T3 return. As stated in the 2004 and 2005 T3 Guides, a trust that holds property that is subject to subsection 75(2) of the Act is required to file a T3 return regardless of whether or not it has tax payable or meets any of the other conditions relating to dispositions and distributions of trust property that would give rise to an obligation to file an income tax return. Certain commentators have challenged your position on this issue, on the basis that subsection 150(1.1) of the Act provides an exemption for individuals, which presumably includes trusts, that have no tax payable for a particular taxation year. Can you comment any further on this issue?

Response

A *T3 Trust Income Tax and Information Return* is both a return of income and a general information return. A T3 trust return serves to report not only information about the reporting trust, but also additional information, such as that affecting the taxation of persons (for example, beneficiaries or settlors) having some connection to the trust. Consistent with this is the additional requirement for the trust to issue a T3 slip to persons whose own income tax requirements may be affected by arrangements involving the trust. These persons include those to whom an amount is attributed from the trust under one of the statutory attribution rules. The information provided under these reporting mechanisms is necessary for the proper administration of the tax system.

These specific reporting requirements are imposed by section 204 of the Income Tax Regulations. The statutory power to promulgate this regulation is not limited to section 150 of the Act – which speaks directly to the requirements for income tax returns – but is also found in section 221 of the Act. Section 221 of the Act contains a broad range of prescribing powers, including the powers to promulgate regulations imposing requirements to file information returns. Therefore, given the nature of the T3 return as both a return of income and an information return, the statutory requirement to file a T3 return exists where the trustee has control of or receives income, gains or profits in the trustee's fiduciary capacity, even if the trustee computes nil income for the trust for tax purposes. This includes circumstances where the trust has no income for tax purposes because subsection 75(2) of the Act applies to recognize amounts as another person's for tax purposes.

The annual T3 Guide published by the CRA provides more specific detail on how a trustee should report amounts that are attributed under subsection 75(2) of the Act.

2006 STEP Round Table
Q4. Application of subsection 75(2) to a Genuine Loan

Interpretation Bulletin IT-258 states that a genuine loan to a trust would not by itself result in property being "held" by the trust under one or more of the conditions under which subsection 75(2) of the Act applies, provided that the loan was outside and independent of the terms of the trust. However, CRA document 2000-0023997 seems to contradict this position. Can you clarify the CRA's current position on the application of subsection 75(2) of the Act when a beneficiary or trustee makes a genuine loan to the trust?

Response

The determination of whether subsection 75(2) of the Act applies in any particular situation can only be made after a full examination of all the relevant facts and circumstances. The apparent inconsistency in this case arises from the fact that the different interpretations are focused on different aspects of the issue and are based on different assumptions of facts.

Before addressing the question, it should be noted that a loan of property could give rise to attribution under various provisions, such as subsection 56(4) or section 74.1 of the Act.

Our position with respect to the application of 75(2) of the Act to a cash loan remains as stated at the 1991 Canadian Tax Foundation. That is, the CRA will not apply subsection 75(2) of the Act to a genuine loan of cash provided that the loan is made outside and independent of the terms of the trust. The CRA's position with respect to what is considered a genuine loan was originally set out in cancelled IT-260, *Transfer of Property to a Minor*. The bulletin stated that no all-inclusive statement could be made as to when a loan can be considered to be genuine, but a written and signed acknowledgment of the loan by the borrower and agreement to repay it within a reasonable period of time would ordinarily be accepted evidence that it was so. If, in addition, there is evidence that the borrower has given security for the loan, that interest on the loan has been paid, or that actual repayment has been made, the loan will be considered to be genuine. The fact that no interest is required to be paid does not in itself, mean that a genuine loan has not been made. If the loan is not considered a genuine loan, subsection 75(2) of the Act will apply in the same manner as for any other transfer of property. Our comments on what constitutes a genuine loan can also be found in CRA document 9811115.

In the context of subsection 75(2) of the Act however, a loan of an income-producing property other than cash, fits squarely within the type of situation described in subparagraph 75(2)(a)(i) of the Act. In such a situation, the trust is holding the income-producing property on the condition and in full expectation of returning the property to the transferor. Although subsection 75(2) of the Act would also apply to the loan of property that is not income-producing, such as a cottage for the use of the beneficiaries, there would be no income to attribute to the person who made the loan of that property.

That is the distinction which was being made in CRA document 2000-0023997.

Note that, while the CRA does not apply subsection 75(2) to a genuine loan of cash, including a conditional sales agreement for the sale of property, solely by reason of the fact that the outstanding debt will be repaid, subsection 75(2) of the Act does apply if a capital beneficiary of a trust transfers property to that trust, regardless of whether or not the capital beneficiary receives fair market value consideration. This is because, as stated in the first paragraph of Interpretation Bulletin IT-369R, *Attribution of Trust Income to Settlor*, the application of subsection 75(2) of the Act does not depend on the manner in which the property was acquired, but on whether the property is held under one or more of the conditions set out in subsection 75(2) of the Act. Thus, if a capital beneficiary of a trust transfers property to that trust pursuant to a conditional sales agreement, subsection 75(2) of the Act will apply to the income from that property on the basis that the property so transferred to the trust may revert to that capital beneficiary. If, however, a person other than a capital beneficiary were to sell property to the trust pursuant to a conditional sales agreement, subsection 75(2) of the Act would not apply solely by reason of the fact that the property may be returned to the vendor pursuant to foreclosure proceedings.

Finally, we would like to offer a comment on the meaning of the word “revert”. Some commentators have suggested that the term “revert” should be restricted to its legal meaning. Although the word “revert“ has a particular meaning in a legal context, it is found in most dictionaries and has the ordinary meaning of “return to its former state”. Thus, it is our position that subparagraph 75(2)(a)(i) of the Act may apply if, under the terms of the trust, there is a possibility, however remote, that the property held by a trust may be returned to the person who contributed the property to the trust.

2006 STEP Round Table
Q5. Outlays and Expenses related to a Deemed Disposition

In computing a taxpayer's gain or loss from a disposition of property, subsection 40(1) of the Act allows the taxpayer a claim for outlays and expenses made or incurred by the taxpayer for the purpose of making the disposition. On the death of an individual taxpayer, subsection 70(5) of the Act deems the taxpayer to have, at the time immediately before the death, disposed of certain of the taxpayer's properties for proceeds equal to the fair market value of the property at that time. What is CRA's position on outlays and expenses in the context of computing a gain or loss arising from deemed dispositions under subsection 70(5) of the Act?

Response

Given the context of the disposition under paragraph 70(5)(a) of the Act (i.e., as a deemed disposition) and given that the Act treats a deceased taxpayer's estate as a taxpayer distinct from the deceased taxpayer, in our view outlays or expenses made or incurred by the taxpayer's estate cannot be claimed under subsection 40(1) of the Act in computing the deceased taxpayer's gain or loss arising from that disposition.

Moreover, in the context of deemed dispositions generally, we are of the view that it is unlikely that any outlays or expenses can be said to be directed to the action of making such dispositions, which are legal fictions created by statute. To the extent that items such as valuation expenses and legal or accounting fees are made or incurred in the context of deemed dispositions, our position continues to be that these will be considered to be made or incurred for the purposes of computing the amount of the proceeds of disposition for income tax purposes, not for the purposes of making the disposition. Therefore, provisions that require that an outlay or expense – in order for it to be claimed – be incurred for the *purpose of making a disposition* will not apply in the context of deemed dispositions. See, for example, CRA document 9503120. In this regard, we understand that some taxpayers have interpreted our comments in CRA document 9312410 as supporting the proposition that outlays and expenses can be made for the purposes of a deemed disposition. However, the reference in that document to a government-imposed disposition should not be read as a reference to a deemed disposition imposed under the Act. That reference is to be read as a reference to an actual event or transaction that is recognized as a disposition under the Act, where the event or transaction results from a government imposed divestment of property (such as an expropriation of land).

Whether an outlay or expense, incurred by an estate in respect of property actually (as opposed to on a deemed event) acquired or disposed of by the estate, can be recognized for tax purposes will depend upon the facts and the relevant statutory provisions.

2006 STEP Round Table
Q6. Consolidated T3 Slips

As of 2004, the T3 slip requires the trustee to show the amount of any adjustments to the ACB of the beneficiary's interest in the trust in Box 42. We are told that some brokers combine the information from various trusts to create one T3 slip. How is a unitholder expected to compute the adjustment for each fund if this is the case?

Response

Effective for 2004, the amount of any return of capital is shown in box 42 of the T3 information slip. A separate T3 slip is required for each fund that provides a return of capital to its investors and has an amount to report in box 42, unless the CRA has authorized the preparer of the information slip to use a customized form that enables the information from several funds to be reported on a consolidated T3 slip. A consolidated T3 slip will only be acceptable if it is accompanied by an information summary that reports the amount shown in box 42 on a fund-by-fund basis for each trust covered by the consolidated slip. An information preparer who wishes to use a customized form should submit a sample customized information slip to the CRA for our approval. The guidelines for making such a request to issue consolidated T3 information slips and the address for obtaining the necessary approval is found in your binder. Note that this information is primarily of interest to investment brokers or mutual fund trust managers who might want to issue consolidated T3 slips to investors. This is because the mutual fund industry had previously identified a need for consolidated T3 slips for administrative reasons, noting that they were already providing the information to their investors on a fund by fund basis in other forms. It is not expected that the trustees of personal trusts would have the same type of administrative difficulties in preparing T3 slips for the multiple trusts which they administer.

If separate T3 slips are not received or a breakdown of the adjustment required for each fund is not provided with the T3 slip, the investor should contact the issuer of the slip for a breakdown of the adjustments required for each fund. CRA documents 2005-0125951E5, 2003-0009837 and 2000-0040053 provide general comments on questions that investors might ask relating to the information slips and related reporting of the information contained on those information slips.

The ACB of a unitholder's holdings in a particular mutual fund trust will be affected by any return of capital as well as by any reinvestment of distributions from the trust. Subsection 248(25.3) of the Act sets out the cost of additional units acquired in satisfaction of a right to enforce payment of an amount by the trust in respect of the unitholder's capital interest in the trust. Chart 1 of the information sheet, RC4169 *Tax Treatment of Mutual Funds for Individuals* provides an example of how to recalculate the ACB of a unitholder's units in a mutual fund trust in a situation where the unitholder is entitled to a distribution of income and capital but chooses to receive that distribution in the form of more units.

It should be noted that:

- even though the requirement to indicate the amount of any return of capital in box 42 has only been effective since 2004, the amount of any return of capital distributed in years before 2004 also reduces the ACB of the units held;
- the amount shown in box 42 is for the current year but the adjustment required to the ACB of the units is cumulative (that is, the unitholder is required to reduce the ACB of the units by the total of all amounts shown in box 42 for each year in which a T3 slip was issued with an amount shown in box 42 as well as by the amounts of any return of capital distributed before 2004); and
- the cost of the additional units as determined under subsection 248(25.3) of the Act does not form part of the amount included in box 42 of the T3 slip.

Consider the following example. Assume that a unitholder purchased 100 units for $10 each in the year. Assume a unit trust earns $200 in gross revenue in a year, which results in income for tax purposes before the deduction of any amount under subsection 104(6) of the Act of $113. The trust subsequently declared $200 to be payable in favour of the unitholder, $113 out of trust income and $87 out the capital of the trust (i.e., the portion of the gross revenue not recognized for tax purposes). The total $200 amount was satisfied not by cash, but by the issuance of an additional 20 units. In this example, the total ACB of the 120 units following the issuance of the additional units would be calculated as follows:

	Number of Units	Assigned cost	Adjustments in computing ACB	ACB
Initial acquisition of units	100	$1,000		$1,000
Of the total $113 of trust income made payable, the T3 slip shows $50 in actual dividends and $63 in other income. The unitholder includes these amounts in income as indicated on the back of the T3 slip				
T3 slip also shows $87 in box 42 as a return of capital			($87)	$913
Cost of additional units as determined under subsection 248(25.3) of the Act	20	$200		$1,113

The result, in this example, is that the total ACB of the capital interest (as represented by the 120 units) at the time immediately after the additional units are issued is $1,113.

GUIDELINES FOR PREPARING A CUSTOMIZED INFORMATION SUMMARY OF T3 TRUST INCOME

Requirements for filers

Canada Revenue Agency (CRA) will authorize the Information Summary and provide you with an approval number if you meet the filing criteria as specified in this document.

1. Produce an Information Summary annually to your clients.
2. The minimum information necessary for each Information Summary transaction is:
    - A single sheet of paper no larger than legal size.
    - A table that prominently reports the Box 42 Return of Capital (ROC) amount on a fund-by-fund basis for each trust in respect of which the custom form provides reporting.
    - The table must clearly identify each separate fund and set out for each the portion of the amount reported in Box 42 of the standard T3 that pertains to it. The table must allow for the entries to be easily understood as return of capital amounts that collectively total and reconcile with the amount reported in Box 42.
    - The CRA word mark must separately appear on the portion of the paper reserved for the table.
    - Display T3 in the upper right hand corner of the page.
    - The custom table must clearly instruct the recipient to retain all portions of the form for tax reporting purposes. The following must appear at the bottom of the page.

        T3 - TRUST INCOME REPORTED IS DISCLOSED YEARLY TO THE CANADA REVENUE AGENCY. YOU MUST RETAIN THIS FORM UNTIL YOU DISPOSE OF THE FUNDS TO CALCULATE THE ACB IN ACCORDANCE WITH THE LAW.
3. The CRA approval number must be clearly printed at the bottom of the Information Summary.
4. Submit a sample client Information Summary Table to the following address for approval:

    Information Returns Section
    Canada Revenue Agency
    E09-8016
    750 Heron Rd
    Ottawa, On
    K1A 0L5

AGENCE DU REVENU DU CANADA
LIGNES DIRECTRICES POUR LA PRÉPARATION D'UN SOMMAIRE D'INFORMATIONS DE REVENUS DES FIDUCIES T3

Exigences de production

L'Agence du revenu du Canada (ARC) autorisera le sommaire d'information et vous remettra un numéro d'approbation si vous rencontrez les critères de production décrits dans ce document.

1. Produire un sommaire d'information annuellement pour vos clients.
2. Les renseignements de base requis pour chaque opération sont les suivants :

    - Une seule feuille de papier pas plus grande que le papier grand format.

    - Un tableau qui indique clairement le montant de la case 42 (RDC) par fond pour chaque fiducie visée par le formulaire personnalisé.

    - Le tableau doit clairement indiquer chaque fond distinct et établir pour chacune de celles-ci la partie qui lui revient du montant déclaré à la case 42 du T3 standard. Les entrées du tableau doivent être clairement représentées en tant que rendement du capital et montants dont la somme équivaut au montant à la case 42.

    - Le logo de l'ARC doit apparaître séparément sur la partie de la feuille réservée au tableau.

    - T3 doit être inscrit dans le coin droit supérieur de la page.

    - Le tableau personnalisé doit clairement indiquer au destinataire de conserver toutes les parties du formulaire aux fins de déclaration d'impôt sur le revenu.

        T3- LE SOMMAIRE D'INFORMATION DES REVENUS DES FIDUCIES EST DÉCLARÉ À L'AGENCE DU REVENU DU CANADA ANNUELLEMENT. CONFORMEMENT A LA LOI VOUS DEVEZ CONSERVER CE FORMULAIRE JUSQU'À LA DISPOSITION DES FONDS AFIN DE CALCULER CORRECTEMENT LE PRIX DE BASE RAJUSTE.

3. Le numéro d'approbation de l 'ARC doit être imprimé clairement au bas du sommaire d'information.
4. Vous pouvez soumettre un échantillon du sommaire d'information à l'adresse suivante aux fins d'approbation :

    Section des déclarations de renseignements
    Agence du revenu du Canada
    E09-8016
    750, ch. Heron
    Ottawa (ON)
    K1A 0L5

2006 STEP Round Table
Q7. Delays in obtaining a Certificate of Compliance under Section 116

It seems that there is a significant delay in processing and issuing Section 116 Clearance Certificates. Can you please provide details as to the current time frame for obtaining a Section 116 Clearance Certificate.

Response

We recognize that there are delays in the processing of requests for Certificates of Compliance pursuant to section 116 of the Act. The definition of "taxable Canadian property" encompasses a broad variety of properties and the disposition of these properties sometimes involves very sophisticated transactions. Since the inventory of requests is handled on a "first-in, first-out" basis and the volume of requests has been increasing over the past few years, delays may be experienced. The requests for Certificates of Compliance are reviewed and processed in the order in which they are received at the Tax Services Office where the property is located. Due to regional variances, the time frames may differ. As a result, an individual would have to contact the Tax Services Office that is processing the request in order to get a reasonable estimate of the time frame to process any particular request. One must remember that a Certificate of Compliance can only be issued once all the required information has been received and reviewed.

2006 STEP Round Table
Q8. Delays in obtaining a Certificate of Compliance under Section 116

In light of the delays, which we are told can be as much as 1 year, even for a routine certificate, what steps are being taken to deal with the back log? What can taxpayers do in the interim?

Response

Our International Tax Directorate has been working with CRA staff in the tax services offices and the Regional offices to develop a risk-based audit strategy in order to make better use of our resources which should reduce the delays for most requests. This requires an analysis of the types of property being disposed of and the type and quantum of adjustments that are made to the taxpayer representations as a result of our review. Unfortunately, this kind of analysis does not happen overnight but we are testing some hypotheses. In the interim, taxpayers should ensure that they provide all relevant information that pertains to the disposition of their taxable Canadian property. If any information is missing, it will create an additional delay in the issuance of the Certificate of Compliance. Where a disposition will occur at a future date, (i.e. a proposed disposition), the non-resident should submit the request for a Certificate of Compliance as early as possible with as much information as possible so that data can be entered into our database. Additional information can be submitted at a later date.

2006 STEP Round Table
Q9. Application of Section 116 to Distributions of Capital from a Trust

It seems that a Clearance Certificate under section 116 of the Act may now be required when a distribution is made to a non-resident from a trust. What is the current policy in this regard?

Response

Generally, a payment after 1999 in satisfaction of all or part of a beneficiary's capital interest in a trust will give rise to a disposition of that part of the beneficiary's capital interest in the trust. A capital interest in a trust resident in Canada (except in most cases, an interest in a mutual fund trust) constitutes taxable Canadian property under the definition of that term in subsection 248(1) of the Act. Therefore, section 116 of the Act will apply when a trust resident in Canada (other than a mutual fund trust) distributes one or more of its properties to a non-resident beneficiary in satisfaction for all or part of the beneficiary's capital interest in the trust.

As stated in paragraph 32 of IC 72-17R4, *Procedures Concerning the Disposition of Taxable Canadian Property by Non-residents of Canada - Section 116*, the objective of these procedures is to protect the revenues of the Crown that are generated by taxes which may be exigible on the income and capital gains realized by a non-resident on the disposition of taxable Canadian property. Although we would agree that in many cases, the distribution of capital from a trust will not result in a capital gain to the non-resident beneficiary, it is possible that such a gain will arise, either because of the application of paragraph 53(2)(g.1) of the Act or because the trust is not a personal or prescribed trust.

Where the non-resident beneficiary can show that no capital gain arises as a result of the disposition of the non-resident's capital interest in the trust (i.e., as shown by the calculation on T2062, Notice of Disposition), the beneficiary will not be required to remit or post any amount as security as the amount shown on the certificate of compliance will equal the full amount of the distribution.

2006 STEP Round Table
Q10. Foreign Reporting Forms

Has the information provided from the foreign reporting forms (such as T1134, T1135, T1141 and T1142) proved useful? Is any consideration being given to changing either the forms or the requirements themselves?

Response

The foreign reporting forms provide the CRA with information about non-resident trusts, foreign affiliates, foreign accrual property income, and assets held outside Canada.

This information has helped to identify where Canadian tax may be at risk. Because audit resources are allocated to issues with the greatest risk of non-compliance, the foreign reporting information has resulted in improved file selection. Therefore, from a tax administration perspective, the foreign reporting regime has proved useful.

The proposed amendments for the taxation of non-resident trusts and foreign investment entities would include changes to the foreign reporting legislation. If these proposals are enacted, we presently expect that the resulting changes to the foreign reporting forms would be relatively minor. For example,

- The T1134 form will remove the references to a trust as a foreign affiliate because, under the legislative proposals, non-resident trusts would no longer be treated as foreign affiliates.

- The T1141 would also be revised to reflect the repeal of concepts such as “specified beneficiary”, “specified foreign trust”, and “non-arm’s length indicator”. These would be replaced with the new concepts and terminology under the proposals. In addition, the instructions would highlight that the form would apply both for contributions to (1) non-resident trusts not deemed resident in Canada and (2) other non-resident entities in respect of which foreign reporting does not otherwise apply.

2006 STEP Round Table
Q11. Late Filing of Foreign Reporting Forms

What is the current position on filing foreign reporting forms after their due date? Is CRA currently assessing penalties in this regard?

Response

In the context of foreign reporting obligations, the Act imposes a number of penalties in different circumstances involving failures to comply. The CRA website has a table summarizing these penalty provisions and what foreign reporting forms are subject to penalties.

Penalties under one of these provisions - subsection 162(7) of the Act - generally apply in the context of foreign reporting where the foreign reporting return is late or incomplete, including circumstances where documents have not been submitted with the return. For example, if a trust agreement has not been submitted with the first filing of the T1141, the return may be considered incomplete and, therefore, late.

In the past, an administrative policy was applied in the circumstances of first-time filers who voluntarily disclosed, before an audit had commenced, a failure to file foreign reporting forms. That policy allowed for the suspension of 162(7) penalties in the context of foreign information reporting. That policy has been revoked. Starting January 1, 2006, penalties are being applied to all late filed foreign reporting returns. Any future requests for relief from these penalties should be addressed to the Voluntary Disclosure program at the local TSO.

The relevant foreign reporting returns include:

T1134-A Information Return Relating to Foreign Affiliates That Are Not Controlled Foreign Affiliates;

T1134-B Information Return Relating to Controlled Foreign Affiliates;

T1135 Foreign Income Verification Statement;

T1141 Information Return in Respect of Transfers or Loans to a Non-Resident Trust;

T1142 Information Return in Respect of Distributions from and Indebtedness to a Non-Resident Trust; and

T106 Information Return of Non-Arm's Length Transactions with Non-residents.

2006 STEP Round Table
Q12. T1141 Transfers or Loans to a Non-Resident Trust

The foreign reporting forms for non-resident trusts make particular reference to protectors. Why is the CRA particularly interested in this?

Response

The T1141 form does not use the term “protector”. However, separate boxes on the form do request - in addition to the identity of the trustee - the names of any persons who have powers relating to the trust or with whom the trustee must consult before the trustee can exercise discretionary powers. While a person acting as “protector” may very well fall into one of these additional categories, the requested information is not limited to persons who may be “protectors”.

This information assists in understanding the true nature of the arrangement involving the trust. This is relevant to ensuring the proper application of the Income Tax Act, including, for example, the determination of the residence of the trust and the application of attribution rules such as those in subsection 75(2) of the Act.

2006 STEP Round Table
Q13. Single Purpose Corporations

Can you give an update on CRA's current assessing position with respect to Canadian corporations which hold U.S. real estate which is personal use property (such as a Florida Condominium used as a residence by the Shareholders)?

Response

Subsection 15(1) provides for the taxation of a benefit from the shareholder's use of the property of a corporation. Prior to 2004, the CRA had an administrative position under which the 15(1) benefit was not taxed in a very narrow set of circumstances relating to the holding of U.S. real estate in a single-purpose corporation

As set out in Income Tax Technical News #32, the implementation of the CRA's current position as announced in Income Tax Technical News #31R2 (ITTN#31R2) relating to the assessment of taxable benefits derived when a single-purpose corporation holds U.S. real estate was deferred until January 1, 2005 in order to facilitate the administration of our new position.

The administrative practice of not assessing a subsection 15(1) benefit will continue to apply to those arrangements that were in place on or before December 31, 2004 until the earlier of:

- the disposition of the particular U.S.-based real estate by the single-purpose corporation; or
- a disposition of the shares of the single-purpose corporation, other than a transfer of such shares to the shareholder's spouse or common-law partner as a result of the death of the shareholder.

Since the implementation of our current position, we have received very few questions concerning the position set out in ITTN#31R2. We have been able to confirm that the transitional relief, described as the exception in the second bullet above, will continue to apply if the shares of a single-purpose corporation are transferred to a spousal trust, rather than directly to the spouse, following the death of the shareholder.

We were also asked whether the administrative practice of not assessing a subsection 15(1) benefit will continue to apply in view of the transitional relief described in ITTN #31R2 in a situation where the single purpose corporation redeems all the shares of its capital-stock owned by the individual who had contributed the funds to acquire the property, leaving the children of the individual as the shareholders of the single-purpose corporation. In such a situation, the administrative practice would not be available in respect of the benefit enjoyed by the remaining shareholders following the redemption of the shares of the individual who contributed the funds to acquire the property. However, if the remaining shareholders had incorporated a new company before January 1, 2005 and that new corporation had used funds provided solely by those shareholders to acquire the property from the existing corporation before January 1, 2005 on a fully taxable basis, that is, without the use of any of the rollover provisions of the Act, the administrative practice and the transitional relief described in ITTN#31R2

would be available provided that the corporation otherwise qualifies as a single purpose corporation.

In addition to meeting the requirements set out in ITTN#31R2 to be eligible for the transitional relief, the administrative practice concerning single purpose corporations only applies where the following seven conditions were met at all times:

1. The corporation must be a Canadian corporation within the meaning of subsection 89(1) of the Act.
2. The corporation's only objective is the holding of a residential real property in the U.S. for the personal use or enjoyment of the shareholder.
3. The shares of the corporation are held by an individual or an individual and persons (other than a corporation) related to the individual.
4. The only transactions of the corporation relate to its objective of holding property in the U.S. for the personal use or enjoyment of the shareholder.
5. The shareholder is charged with all the operating expenses of the property by the corporation, with the result that the corporation shows no profit or loss with respect to the property on any of its income tax returns.
6. The corporation acquired the property with funds provided solely by the shareholder and not by virtue of his holdings or that of a related person in any other corporation.
7. The property must be acquired by the corporation on a fully taxable basis, that is, without the use of any of the rollover provisions of the Act.

2006 STEP Round Table
Q14. Attribution of FAPI under Subsection 75(2)

When subsection 75(2) of the Act applies to shares of a foreign corporation held by a trust that is taxable under paragraph 94(1)(c) of the Act, how does one determine the amount to be attributed to the contributor? In particular, can the amount of income that was attributed to the contributor be changed if the foreign corporation realizes a loss in a subsequent year?

Response

With respect to the computation of the amount to be attributed to a taxpayer under subsection 75(2) of the Act, the income or loss from property, or taxable capital gains or allowable capital losses from the disposition of property are to be computed in accordance with Division B of Part I of the Act. When the property in question is shares of controlled foreign affiliate held by a trust resident in Canada (including a trust that is deemed to be resident in Canada), the income to be attributed to the Canadian resident is the amount of any dividends received on the shares and any amount determined under section 91 in respect of those shares.

With respect to losses realized by the foreign corporation in other years, there is a proposal to amend section 5903 of the Regulations to allow a deductible loss of a particular controlled foreign affiliate of a taxpayer as computed under section 5903 of the Regulations to be applied to reduce the amount of FAPI included in the taxpayer's income for one or more of the three preceding years or any of the seven subsequent years. Provided that the amendment to the Regulation is enacted in substantially the same form as that released by the Department of Finance on March 16, 2001, a taxpayer will be able to claim such portion of the deductible loss of the controlled foreign affiliate of that taxpayer as is determined by section 5903 of the Regulations to reduce the amount included in income as FAPI in any of the three previous years immediately preceding the loss year as well as in any seven of the years subsequent to the loss year.

When a controlled foreign affiliate of a trust realizes a loss in a particular taxation year and that trust holds property under one of the conditions described in subsection 75(2) of the Act, the issue arises as to which taxpayer, the trust or the person to whom the income was attributed, is entitled to claim the deductible loss and what mechanism ensures that the amount of the deductible loss available for any other taxation year is reduced appropriately. A deductible loss, as computed under the proposed amendment to section 5903 of the Regulations, will be deductible by the trust to the extent that it reduces the computation of FAPI included in the trust's income for another year, except to the extent that such income was attributed to the person who transferred the shares to the trust under subsection 75(2) of the Act. Where that income was attributed to another taxpayer, the taxpayer who has included an amount of FAPI from a particular controlled foreign affiliate in that other taxation year by reason of the application of subsection 75(2) of the Act would be able to claim such portion of the deductible loss as determined by section 5903 of the Regulations in order to reduce the amount included in income in that other taxation year, provided that the conditions in subsection 75(2) of the Act are met in respect of the loss year.

Under the proposed amendments to section 5903 of the Regulations, the amount so claimed will reduce the amount of deductible loss available to be claimed by either the trust or the taxpayer in any other taxation year.

Addendum: The following Questions and Answers were prepared for the 2006 STEP Round Table but time did not permit the questions to be addressed at the Conference (Q 15 through to Q17)

2006 STEP Round Table
Q.15 Majority-interest Beneficiaries of an Estate

Who is the majority-interest beneficiary in an unadministered estate for the purpose of subsection 251.1(1) of the Act? Some commentators have noted that it may be difficult to determine each beneficiary's share of the income and capital of the estate if the amount of the testamentary debts is not known. For example, if one beneficiary is entitled to a specific bequest of $100,000 and the other beneficiary is entitled to the residue of the estate, the determination of who is entitled to the majority of the capital of the estate depends on the amount of capital available to be distributed to the beneficiaries after the payment of all of the testamentary debts.

Response

It is a question of fact as to whether any heir is a majority interest beneficiary at any particular point in time. A majority interest beneficiary is defined in subsection 251.1(3) of the Act to be "a person whose interest as a beneficiary, if any, at that time

(a) in the income of the trust has, together with the interests as a beneficiary in the income of the trust of all persons with whom the person is affiliated, a fair market value that is greater than 50% of the fair market value of all the interests as a beneficiary in the income of the trust; or

(b) in the capital of the trust has, together with the interests as a beneficiary in the capital of the trust of all persons with whom the person is affiliated, a fair market value that is greater than 50% of the fair market value of all the interests as a beneficiary in the capital of the trust."

Such an interest could be immediate or future, absolute, contingent or discretionary. If the amount of income or capital that the beneficiary may receive under the trust depends on the exercise or failure to exercise a discretionary power by any person, paragraph 251.1(4)(d) of the Act must be considered.

While it may be difficult at times to value the respective interests in an estate, in most cases, including the period of administration of an estate, it should be possible to make a reasonable estimate of the fair market value of each of the interests such that the majority interest beneficiaries of the estate can be identified. For example, if one beneficiary of the estate is entitled to a specific amount while the other is entitled to the residue of the estate, one would expect to find, in the absence of any wording in the will to the contrary, that the residual beneficiary would be entitled to all of the income of the estate such that the residual beneficiary would be a majority interest beneficiary of the estate. The determination of whether the other beneficiary was also a majority interest beneficiary of the estate would depend on the estimated value of the estate at the relevant time.

It is recognized that the status of a beneficiary of an estate as a majority interest beneficiary of the estate could change over the course of time. For example, a disgruntled heir could make a successful court challenge with respect to his or her share of the inheritance with the result that one or more of the majority interest beneficiaries of the estate could lose his or her status as a majority interest beneficiary and another person could become a majority interest beneficiary. A person with a competing claim to challenge the wording of the will would not be considered to be a majority interest beneficiary solely by reason of that claim until such time as the claim is established by the court. If a competing claim is successful and one or more of the beneficiaries of the estate ceases to be a majority interest beneficiary, that beneficiary will cease to be affiliated with the estate at the time that he or she ceases to be a majority interest beneficiary of the estate.

2006 STEP Round Table
Q.16 Amounts Payable by the Trust

Some commentators suggest that subsection 104(24) of the Act applies to determine whether amounts allocated by a trust to a beneficiary must be included in computing the income of a beneficiary. What is the CRA's view on the role of subsection 104(24) in determining the amount, if any, of a beneficiary's income inclusion for a given taxation year?

Response

Subsection 104(24) applies for the purposes of subparagraph 53(2)(h)(i.1) and subsections 104(6), 104(7) 104(13), and 104(20) of the Act. These five provisions – involving the income taxation of trusts and their beneficiaries – apply in respect of an amount only to the extent that an amount has become payable. Therefore, in order to apply the provisions, it must first be determined that the relevant amount has become payable.

Subsection 104(24) of the Act applies for the purposes of the above provisions to deem an amount, that has otherwise become payable to a beneficiary, not to have become payable to a beneficiary in a taxation year. The deeming rule does not apply, however, in respect of an amount that has otherwise become payable where the amount is paid in the taxation year to the beneficiary or the beneficiary was entitled in the taxation year to enforce payment of the amount.

Our view is that it is only if, on the applicable facts, an amount has first been determined to have become payable to a beneficiary and then also been determined either to be paid in a particular taxation to the beneficiary or become subject to an entitlement in the particular taxation year on the part of the beneficiary to enforce payment of it will the amount's status as an amount that has become payable in the particular taxation to the beneficiary be preserved for purposes of subparagraph 53(2)(h)(i.1) and subsections 104(6), 104(7) 104(13), and 104(20) of the Act.

Our administrative practice, however, has been to accept that an amount has become payable in a taxation year to a beneficiary for purposes of those provisions if, in the circumstances, it has been paid in the taxation year to the beneficiary or the beneficiary is entitled in the taxation year to enforce payment. It is in light of this position that the CRA's publications continue to sometimes refer to subsection 104(24) of the Act as "defining" whether an amount has become payable for the applicable provisions.

If an amount has, with regard to subsection 104(24), become payable to a beneficiary by a trust, the determination of whether that amount must be included in the beneficiary's income for tax purposes is not made under subsection 104(24) of the Act. Rather, the determination of whether and, if so, when the amount must be included in the beneficiary's income is made with regard to subsection 104(13) of the Act.

For a more detailed discussion, we refer you to CRA document 2005-015908.

2006 STEP Round Table
Q.17 Distribution of Property from a Bare Trust

A bare trust is not recognized for the purpose of the Act because subsection 104(1) of the Act provides that, in situations where the trustee can reasonably be considered to act as agent for all the beneficiaries in respect of all dealings with the trust property and the trust is not a trust described in any of paragraphs (a) to (e.1) of the definition “trust“ in subsection 108(1), the arrangement is not considered to be a trust for all but a few purposes of the Act. When an individual transfers property to a bare trust, no disposition is recognized because there is no change in beneficial ownership. However, paragraph (b)(v) of the definition of “disposition“ in subsection 248(1) of the Act has the effect of creating a disposition when the trustee of a bare trust ceases to act as such in respect of the trust property. One interpretation of this provision would result in a disposition whenever a bare trustee distributes the property back to the sole beneficiary of the trust who is also the sole contributor to the trust. Can you comment on this?

Response

The short answer is that there is no disposition in the situation you describe because of paragraph (e) of the definition of disposition in subsection 248(1) of the Act. A more complete explanation of our analysis is available in CRA document 2006-0174831E5.

In general terms, subsection 104(1) of the Act provides that, in situations where the trustee can reasonably be considered to act as agent for all the beneficiaries in respect of all dealings with the trust property and the trust is not a trust described in any of paragraphs (a) to (e.1) of the definition “trust” in subsection 108(1) of the Act, the arrangement is not considered to be a trust for all but a few purposes of the Act. For the purpose of our response, we will refer to this trust as a bare trust.

Subparagraph (b)(v) of the definition of “disposition” in subsection 248(1) of the Act provides that for the purposes of the Act, a disposition includes an event by which a trustee of such a trust ceases to act as agent for any of the beneficiaries in respect of any dealing with the trust property.

While a “disposition” as defined in subsection 248(1) of the Act includes the transactions and events described in paragraphs (a) to (d) of that definition, it does not include the transactions and events described in paragraphs (e) to (m) of that definition. Since paragraph (e) of the definition of “disposition” is not one of the provisions for which a bare trust is considered to be a trust, the transfer of property by a person to a bare trust under which that person is the sole beneficiary or the transfer of that property back to that person from such a trust would not result in a disposition for the purposes of the Act.

If, however, the nature of the trustee’s role with respect to the trust property held on behalf of a beneficiary changes such that subparagraph (b)(v) of the definition of disposition in subsection 248(1) of the Act applies but the trustee retains the trust property (i.e., the trustee takes on the active duties of being a trustee), paragraph (e) would not apply as no actual transfer has taken place. In such a situation involving a beneficiary who is also the settlor of the trust, the beneficiary\settlor would recognize a

disposition of the property to the trust at that time, even though the actual transfer to the trustee occurred at an earlier time.

Note that while a bare trust can be established for someone other than the settlor, the transfer of property from the settlor to such a bare trust would result in a change of beneficial ownership and thus the settlor would be required to recognize the gain or loss arising from the disposition of property at that time.