2007 STEP Canada National Conference

CRA Round Table

June 8, 2007

Question No. 1: In-trust Accounts

In-trust accounts can be agency arrangements, true trusts or neither, in that the assets remain the property of the transferor. The existence of a trust depends upon the relationship between the settlor, the trustees and the beneficiaries and whether the three certainties are present, namely certainty of the settlor's intention to create a trust, the property placed in trust and the beneficiaries of the trust. What is the CRA's view of in-trust accounts and how does it determine the nature of the account?

CRA Response:

There is a great deal of uncertainty and\or misinformation concerning "in-trust accounts". The CRA's position has consistently been that the determination of the nature of an "in-trust" account has to be made on a case by case basis in light of the specific facts, but we continue to receive a steady flow of enquiries about the status of such accounts for tax purposes. The legal relationship between the parties must be determined before applying the *Income Tax Act* (the "ITA"). Some financial institutions have issued bulletins and leaflets explaining what a trust is and the benefits of creating a trust for the benefit of minors. Some promotional documents make a distinction between a formal and an informal trust, emphasizing that a formal trust is usually drafted by a lawyer and indicates how the assets are to be administered, the duration of the trust and how the assets are to be distributed whereas an informal trust is only documented by the investment contract.

For tax purposes, no distinction is made between a formal trust and an informal trust except that it is typically more difficult to establish whether an informal trust is in fact a valid trust. As noted in the question, the three certainties must be present in order for a trust relationship to be established. It will often be very difficult for the person creating the trust - typically a parent of the child - to prove that the three certainties are met unless the creation of the trust has been clearly documented. While the CRA recognizes that a formal trust deed is not required in order to establish a trust, a parent who wants a reasonable degree of certainty as to whether the CRA will agree that a trust has been established for the child would be well advised to set out the terms and conditions of the trust in a formal trust deed and to handle the trust funds in accordance with the terms and conditions so established. If there is a trust, a T3 return will typically be required.

If the arrangement is not a trust, what is it? In some cases, the courts have concluded that there was an immediate gift of the property and in other cases, the courts have concluded that the property continued to be part of the assets of the purported transferor. The actions of the adult who has signing authority on the account in dealing with the property will be relevant in determining which applies. Two recent Supreme Court cases dealing with estate litigation, *Pecore v. Pecore* (2007 SCC 17) and *Madsen Estate v. Saylor* (2007 SCC 18), highlight the importance of documenting the transferor's intent. CRA document 2002-017676 provides an in-depth analysis of some of the issues to be considered in determining the nature of an in-trust account.

If the nature of the arrangement is such that no trust is established and the facts, including the manner in which the parent handles the account, indicates that no actual transfer of property has been made to the child, the income from the in-trust account would remain that of the parent who transferred the funds to the in-trust account.

If the in-trust account represents an actual transfer of property to the child at that time the property is deposited to the account, such that the parent acts solely as the child's agent or guardian of the child's property, the income from the account will be that of the child, subject to the application of the attribution rules.

With respect to the attribution rules, where the funds are held in a trust, there will typically be a concern with subsection 75(2) or section 74.3 of the ITA, and a concern with subsection 74.1(2) of the ITA if the funds have been transferred to the child directly with the parent acting as agent, guardian of the child's property or as a joint account holder. Where the funds deposited to the in-trust account are limited to the amounts received as a child tax benefit or a universal child care benefit, the attribution rules in subsection 74.1 and 74.3 of the ITA will not apply.

Question No. 2: Requirement for a Social Insurance Number

In Technical Interpretation # 9812245 (dated June 22, 1998) the CRA indicated that the social insurance number (SIN) of a child (under age 18) is not required if the child's income is expected to be $2500 or less. The CRA also commented that the SIN to be recorded on the information slip would depend on whether the attribution rules apply – if they apply, the parent's SIN must be used; if they do not apply, the child's SIN is to be used. Does the above represent CRA's position, and if so, how is the issuer of the information slips to know which SIN should be used?

CRA Response:

The answer to this question depends in part on which issuer of information slips is being referred to and on the nature of the legal relationship between the parties. Where the funds held in the account are trust property, the financial institution holding the funds may be required to issue a T5 *Information Slip* or a T5008 *Statement of Securities Transaction*s to the trust and the trustee will be required to issue a T3 *Information Slip* to the beneficiaries for such portion of the trust's income as became payable to them during the year. As stated in the relevant guides for preparing T5 *Information Slips* and T5008 *Statement of Securities Transactions,* a social insurance number is not required for an information slip that is required for a trust. As noted in the previous question, the determination of the legal relationship between the parties may not be obvious but for the purpose of determining whether the financial institution must obtain a social insurance number in respect of the account, the exception for trusts only applies where the trust is governed by a trust indenture or trust deed and not simply in the investment contract. This position is set out in paragraph 8 of Information Circular 82-2R2, *Social Insurance Number Legislation that Relates to the Preparation of Information Slips*.

As noted in the previous question, where the funds are held in a trust, a T3 *Trust Income Tax and Information Return* will normally be required. The trustee must provide the social insurance number of the beneficiaries to whom income has been allocated, except where the conditions in Information Circular 82-2R2 are met – that is, where the child is under 18 years old and is expected to have a annual income of $2,500 or less.

Where the funds are held in the child’s name only, with the parent acting as agent or guardian of the child’s property, the financial institution would issue the appropriate information slip in the name of the child. If the parent is also listed as a joint account holder, the financial institution would issue the appropriate information slip in the name of both the parent and the child in the same manner as for other joint account holders. In either case, the child’s social insurance number would not be required where a beneficiary is under 18 and the beneficiary’s total income is expected to be less than $2,500 as noted in Information Circular 82-2R2. If the parent is listed as a joint account holder, the parent’s social insurance number will be required in all cases.

The application of the attribution rules does not impact on whose social insurance number is required on the information slip as the payor is not normally in a position to determine the extent to which the attribution rules apply.

Question No. 3: Commencement Date of a Testamentary Trust

The definition of “testamentary trust” in subsection 108(1) of the ITA and the clarifying provisions of subsections 248(8) and 248(9.1) of the ITA are relevant in situations where a deceased taxpayer provides provisions in his /her will to create a trust. However, the provisions are not explicitly clear on the timing of when such a testamentary trust is created. Can the CRA provide comments as to when it views a testamentary trust to be created? Can the CRA ever envision circumstances where such a trust could be created at a time long after the time of the decedent's death while still retaining the status of a testamentary trust?

CRA Response:

A testamentary trust is defined in subsection 108(1) of the ITA as a trust or estate that arose on and as a consequence of the death of an individual, subject to certain conditions. Consequently as stated on page 7 of the 2006 *T3 Trust Guide*, a testamentary trust is generally created on the day that a person dies.

With regard to the last query, the terms of the will may provide that on the death of the first generation beneficiary (e.g., the spouse or common law partner), the trustee is to divide the remaining property into equal parts for the children and then create a new trust for the interest of each child. The trusts for the interest of each child would be testamentary trusts as they may be said to arise on and as a consequence of death even though the official create date of the new trusts is at a later point in time.

With respect to the application of the "21 year deemed disposition rule," it should be noted that the deemed disposition date of the new trusts will be determined in accordance with the rules set out in subsection 104(5.8) of the ITA.

For further commentary, see CRA documents 9226315 and 9801035.

Question No. 4: Subsection 75(2) and Loans: Implications of the *Howson* Decision

In the recent decision of *Howson* v. *The Queen*, 2007 DTC 141 (TCC), the taxpayer had transferred property to an "immigration" trust, of which she was the beneficiary. The issue was whether the property was transferred by way of gift or loan, and whether subsection 75(2) of the ITA applied to attribute the income of the trust to the taxpayer. The Crown conceded that if there were a genuine loan, subsection 75(2) of the ITA would not apply. In the past, the CRA has taken the view that to be a genuine loan, there must be: (1) a written and signed acknowledgment of the loan by the borrower and an agreement to repay it within a reasonable period of time; (2) evidence that the borrower gave security for the loan; (3) evidence that interest on the loan was paid; and (4) evidence that actual repayment was made. In *Howson*, no interest was charged and there was no security granted. The Court held that the transfer was made by way of loan and stated that neither interest nor security is required to have a loan. The Court also found that a bona fide loan is not subject to "reversion" by the terms of the Trust – it returns to the lender by operation of the loan itself and the laws affecting creditors.

Has the CRA changed its position with respect to the application of subsection 75(2) to loans?

CRA Response:

The CRA is prepared to provide a qualified change in position.

As background, we advise that the difficulty for the CRA has always been distinguishing between a loan and a contribution to the corpus of the trust fund. It would appear that the comments in paragraph 1 of IT-369R were developed in light of this difficulty. That paragraph asserts that a genuine loan to a trust would not by itself be considered to result in property being "held" by the trust under one or more of the conditions specified in subsection 75(2) of the ITA, if the loan is outside and independent of the terms of the trust.

In *Howson*, the issue at trial was narrowed to whether the funds were put in the trust by way of loan. Based on the evidence before the Court, the Court determined that the funds were put in by way of loan and that subsection 75(2) of the ITA did not apply.

At paragraph 15 of the decision, the Court states: "It stands to reason that a *bona fide* loan is on its face, not subject to reversion by the terms of the Trust. It returns to the lender by operation of the loan itself and the law of creditor rights." Later, in paragraph 21, the Court states: "A finding of a loan does not require interest nor security."

To the CRA these comments mean that something called loan must be regarded as a loan at law. As acknowledged by the Court in *Howson*, although property held by a trust pursuant to a *bona fide* loan will eventually revert to the creditor, given that such reversion will usually not flow from the terms of the trust but by operation of the loan itself and the law of creditor rights, it follows that such property should not be subject to subsection 75(2) of the ITA. Therefore, absent the particular scenario where a loan to a trust is not outside and independent of the terms of the trust, we are of the view that a loan to a trust falls outside the ambit of subsection 75(2) of the ITA and should rather be dealt with under subsections 56(4.1) and 74.1(1) to (3) of the ITA.

Question No. 5: Compliance Problems in Trust Reporting

It is becoming increasingly common for trusts to have investments in other trusts. These investments may be income trusts, or mutual funds that are structured as trusts. In such circumstances, the filing due date for the trust is coincident with the date on which T3 information slips are to be furnished. Thus, as a practical matter, it is difficult to complete a tax return for the trust by the due date. This difficulty was acknowledged in the March 19, 2007 federal budget. Until this matter is resolved in some way, possibly by legislative amendment, what would you advise practitioners to do in these circumstances? It is noted that while it is possible to file an amended T-3 return, it is not possible to retroactively make income payable to a beneficiary.

CRA Response:

The CRA has long recognized this difficulty. The difficulty arises because the T3 is both an income tax return and an information return with the result that a trust issuing a T3 slip and a trust receiving a T3 slip have the same filing deadline. Section 132.11, the provision in the *Income Tax Act* that allows a mutual fund trust to elect to have a taxation year of December 15th rather than December 31st, was intended to alleviate, in part, the problem created by concurrent filing deadlines. As noted in the question, the 2007 federal budget stated that the government is working with the investment funds industry to develop a process that will balance the trustees' need to have sufficient time to compute the trust's income for the year and the beneficiaries' need for timely information concerning the income that was made payable to them in the year. The government expects to release the new draft regulations in time for the 2007 taxation year filing deadlines.

Obviously, nothing prevents a trust, including a mutual fund trust, from filing its T3 *Trust Income Tax and Information Return* early to ensure that all of its beneficiaries will have the T3 information slips in time to file their respective income tax returns. Even so, a trustee of a trust that is itself the beneficiary of another trust is often faced with the difficulty of completing the trust's tax return without having received the T3 information slips from the trusts in which it holds an interest. As outlined in the T3 Guide and consistent with the other guides for filing income tax returns, where the preparer of a trust return does not have all of the information slips needed to complete the return when it is due, the income should be estimated. If the estimate differs from the actual amounts shown on the information slips, the information slips, including any revised information slips that are being issued by the trust, should be sent to the Ottawa Technology Centre accompanied by a letter requesting an adjustment to the trust's tax return.

The comment made with respect to the inability to retroactively make income payable is a good point. A trust is only entitled to a deduction under subsection 104(6) of the ITA for amounts of income that became paid or payable to the beneficiaries in the year in which the income was earned, and is not entitled to a deduction for amounts that only became payable after the end of the year. For a detailed discussion on the meaning of "paid or payable" for the purposes of subsections 104(6) and 104(13) of the ITA, we refer you to CRA document 2005-015908. Generally, an amount will be considered to have become payable in a taxation year to a beneficiary for purposes of these provisions if, in the circumstances, the amount was paid in the taxation year to the beneficiary or the beneficiary was entitled to enforce payment of the amount in the taxation year. In determining whether an amount was payable to the beneficiaries before the end of the taxation year in which the income was earned, we would look to the terms of the trust and any resolutions of the trustees in respect of the exercise of any discretion they might have in respect of the distribution of the trust's income.

Question No. 6: Attribution and Subsections 20(11) & (12)

Where:

(a) a Canadian inter-vivos revocable trust is created in such a manner that subsection 75(2) of the ITA applies to attribute the income earned by the trust from certain property to be income of the transferor and not income of the trust;

(b) property is contributed to a trust and the anti-avoidance rule in subsection 56(4.1) of the ITA applies to deem the income earned on the property to be the income of the transferor and not income of the transferee;

(c) the attribution rule in subsection 74.1(1) of the ITA applies to an individual that has transferred property, by means of a trust, to or for the benefit of the individual's spouse or common-law partner, such that the income earned by the trust from the property is deemed to be the income of the individual and not income of the spouse or common-law partner; or

(d) the attribution rule in subsection 74.1(2) of the ITA applies to an individual that has transferred property to a trust, to or for the benefit of a related minor, such that any income earned by the trust from the property is deemed to be the income or loss of the individual and not the minor; and

in each case above the portion of the income earned by the trust, that is attributable to such property, is foreign non-business income that is attributed to the person who contributed the property to the trust. However, it is the trust that pays any foreign non-business income tax on any such non-business income earned by the trust.

Does the foreign non-business income tax paid by the trust also attribute to the person that is deemed to have received the foreign non-business income earned by the trust or does it remain in the trust where, because of attribution the trust does not have any foreign non-business income, it will not be creditable? In such circumstances, is the foreign non-business income tax deductible under subsections 20(11) or 20(12) of the ITA by the person who contributed the property to the trust?

CRA Response

There is no mechanism in any of subsections 75(2), 56(4.1), 74.1(1) or 74.1(2) of the ITA that would allow the foreign non-business income tax paid to the government of a foreign country by the trust to be viewed as having been paid by the person who must report the attributed income (the "Transferor"). Subsection 126(1) of the ITA requires that any non-business income tax must have been paid by the taxpayer claiming the foreign tax credit. Since it is the trust that paid the tax, the Transferor is not eligible for such a credit.

For the purposes of subsections 75(2), 56(4.1), 74.1(1) or 74.1(2) of the ITA, the income from property of a trust is computed at the trust level. The deductions permitted under subsections 20(11) and 20(12) of the ITA may be claimed in computing such income from property. Therefore, if the trust is resident in Canada, and the requirements for the application of those provisions are otherwise satisfied, deductions under both subsection 20(11) and subsection 20(12) of the ITA may be claimed in computing the amount attributed to the Transferor.

Question No. 7: *MIL Investments* and Treaty Shopping

In light of the *MIL Investments* decision, would you please give an update on CRA's policy concerning so-called "treaty shopping."

CRA Response:

The CRA policy concerning treaty shopping was unaffected by the Tax Court decision in *MIL Investments*. That decision was appealed by the CRA in part because it rejected the notion that treaty shopping is contrary to the object and purpose of tax treaties and the intent of parties thereto. This is not only contrary to the views of the CRA but the Supreme Court as discussed in *Crown Forest* v. *The Queen* (95 DTC 5389(SCC)), as well as the tax policy of the Department of Finance.

As indicated in *Income Tax Technical News* No. 35 dated February 26, 2007 regarding treaty residence, the CRA considers abusive any arrangement where a person attempts to set up residence in a treaty country in order to gain treaty benefits in a manner that does not create any material economic nexus with that country.

Question No. 8: When a resident of Canada receives a distribution from a non-resident trust or estate following the death of a parent, is the resident of Canada required to file Form T1142, *Information Return in Respect of Distributions from and Indebtedness to a Non-Resident Trust*?

CRA Response:

Form T1142 is generally required to be filed when a person receives a distribution of property from, or is indebted to, a non-resident trust. Section 233.6 of the ITA provides an exemption from filing form T1142 in respect of a distribution from a non-resident estate that arises on and as a consequence of the death of an individual. Thus, form T1142 does not have to be filed by a person who receives a distribution from a non-resident estate during the period of administration of that estate, which is normally the year following the death of the individual – in this example, the parent. However, once the estate has been administered, the Canadian beneficiary of any ongoing non-resident testamentary trust must file form T1142 in any year where a distribution is received from the trust or where the Canadian beneficiary becomes indebted to the trust.

If the non-resident trust is a trust that was created before the death of the parent and the Canadian beneficiary is entitled to receive distributions only after the death of that parent, the trust is not an estate that arose on and as a consequence of the death of an individual. Therefore, a distribution from such a non-resident trust following the death of the parent must be reported on form T1142 filed by the beneficiary who received the distribution. For further commentary, see CRA document 2000-0047355.

Question No. 9: Departure from Canada

In 1920, the great grandfather of our taxpayer established an inter vivos trust for the benefit of his issue. Great grandfather was a U.S. citizen resident in the United States, and the property transferred to the trust included shares of a U.S. operating company and U.S. real estate (a ranch which continues to operate). Our taxpayer ("Mother") came to Canada as a student in 1979, married a Canadian citizen and had two children (one now attending university in the United States and the other still a minor). When her father died in 1990, our Canadian resident (but U.S. citizen) taxpayer became entitled to receive income during her lifetime, and on death, she has the power to appoint the capital of the trust to her husband and children in her will. Since the elder child is attending school in the United States, the family has decided to move south, closer to old family connections. What are the departure tax consequences to our taxpayer, her husband and children in respect of the trust created by the great grandfather?

CRA Response:

Subsection 128.1(4) of the ITA deems a taxpayer who has ceased to be resident in Canada to have disposed of each property owned by that taxpayer immediately before the taxpayer ceased to be resident in Canada, subject to the exceptions listed in subparagraphs 128.1(4)(b)(i) to (v) of the ITA. The definition of "property" in subsection 248(1) of the ITA clarifies that property includes a right of any kind. As a result, and subject to the exceptions described in subparagraphs 128.1(4)(b)(i) to (v) of the ITA, a beneficiary of a trust will be deemed to have disposed of his or her right as a beneficiary, whether that right is immediate or future, absolute or contingent or whether it is conditional on, or subject to, the exercise of any discretion by any person. Consequently, the answer to this question depends in large part on the terms and conditions of the trust establishing who has rights as a beneficiary under the trust and in particular, on the terms and conditions of the power of appointment. For example, does the power of appointment include a gift over in default of appointment and does Mother hold the power of appointment as a trustee? With respect to powers of appointment generally, some legal commentators have taken the view that, under a general power of appointment, the potential appointees are not be considered beneficiaries at law until appointed, but that under a special power of appointment, a potential appointee could be viewed as a beneficiary at law from the date the power of appointment was granted.

For the purpose of this example, we will assume that the power to appoint is a general power of appointment that is only exercisable in Mother's will and that if she fails to exercise it, the capital of the trust will be distributed among the remaining beneficiaries of the trust. As a result, the husband will be a potential appointee under the power of appointment and will not be a beneficiary of the trust at the time of departure. Although the husband is a "successor beneficiary" of the trust for the purpose of proposed sections 94 and 94.1, as a potential appointee under a general power of appointment, he does not have any rights under the trust at the time of departure and thus does not realize a deemed disposition in respect of the trust for the purpose of section 128.1 of the ITA.

If the terms of the trust as established by Mother's great grandfather provide benefits for all of his issue, one would expect that the children would also currently be beneficially interested in the trust since they too are his descendents. As a result, they would each have a beneficial interest in the trust at the time of departure even though their right to any of the income or capital of the trust would presumably be contingent at that time.

Assuming that both Mother and her children are currently beneficiaries of the trust, both Mother and her children would realize deemed dispositions of their respective interests in the trust on their departure unless one of the exceptions in subparagraphs 128.1(4)(b)(i) to (v) of the ITA applies. Since Mother has been resident in Canada for 26 years as of December 31, 2006, the exception in subparagraph 128.1(4)(b)(iv) does not apply nor is her interest in the trust an "excluded right or interest" as defined in subsection 128.1(10) of the ITA. The two excluded rights relating to an interest in a personal trust are contained in paragraphs (j) of that definition – which deals with personal trusts resident in Canada – and (k) –which deals with non-resident testamentary trusts. Likewise, these exceptions will not apply to the children's interests in the trust.

Thus, Mother and the children will realize a deemed disposition of their respective beneficial interests in the trust on their departure from Canada. The application of paragraph 107(1)(a) of the ITA may reduce the amount of the gain realized on the capital interests as noted in the example given in CRA document 2004-0061841E5. Paragraph 107(1)(a) of the ITA will have no application in computing Mother's income inclusion under paragraph 106(2)(a) of the ITA as a result of the deemed disposition under paragraph 128.1(4)(b) of the ITA for any portion of her interest in the trust that is an income interest in the trust.

If either Mother's or children's interest in the trust is a participating interest in a foreign investment entity as defined in proposed section 94.1 of the ITA, any amount that is included in their respective income under that provision before their departure would increase the adjusted cost base of their respective interests for the purpose of computing the capital gain arising as a result of the deemed disposition. In addition, if Mother's interest in the trust is a participating interest as defined in proposed section 94.1 of the ITA, all of her interest in the trust will be a capital interest in the trust, and not an income interest, in the trust because of the proposed changes found in Bill C-33 to the definition of "income interest" in subsection 108(1) of the ITA.

With respect to paragraph (j) of the definition of "excluded right or interest" in subsection 128.1(10) of the ITA, it should be noted that this trust would not be deemed resident in Canada under proposed subsection 94(3) because there is no "resident contributor" or "connected contributor" to the trust. With no "connected contributor" (a person who contributed property while resident in Canada or within 60 months before becoming resident in Canada or within 60 months of ceasing to be resident in Canada), the trust does not have a "resident beneficiary" as that term is defined in proposed subsection 94(1) of the ITA and is not deemed resident in Canada. If the trust had been deemed resident in Canada under proposed subsection 94(3), both Mother's interest in the trust and that of her children would have been an excluded right as defined in subsection 128.1(10) of the ITA for the purpose of the deemed disposition rules.

Question No. 10: Deemed Resident Trusts under the Proposed Legislation

Canadian resident and citizen taxpayer ("Mother") has two adult children. One child attended university in the U.S. and has now decided to take up residence there (she married a U.S. person). The other child plans to remain in Canada. Mother wants to create a will that splits her estate 50/50 between her two children (her husband has died). To minimize U.S. estate tax on the death of her U.S. resident child, she plans to put 50% of the estate into a U.S. resident trust, with U.S. resident trustees. The beneficiaries of this trust will be her U.S. resident daughter and her children. The balance of the estate will go directly to the Canadian resident beneficiary.

The U.S. resident daughter will be one of the three trustees of the U.S. trust. The trust will last beyond her lifetime. There is a power to pay income to her and to her grandchildren, and to encroach on capital for the health, maintenance and education of her children. However, if this daughter dies without issue, or all her issue are deceased, the residue of the trust will go to the Canadian resident beneficiary and ultimately to her children.

Will the U.S. trust be deemed to be resident in Canada under proposed subsection 94(3) of the ITA? Will the Canadian child be considered to have an interest in a non-resident trust?

CRA Response:

Since the daughter who is resident in Canada would be a “successor beneficiary” as defined in proposed subsection 94(1) of the ITA as long as her sister and her sister’s children are alive, the trust would not be deemed resident in Canada under proposed subsection 94(3) of the ITA following Mother’s death and during the period in which any of the other beneficiaries of the trust are alive and not resident in Canada.

Our analysis of the tax consequences is as follows:

A trust will be deemed resident in Canada under the proposed legislation if it has either a “resident contributor” or a “resident beneficiary” as those terms are defined in proposed subsection 94(1) of the ITA.

If the trust created by Mother is established on her death, Mother will be a “connected contributor” but not a “resident contributor” as those terms are defined in proposed subsection 94(1) of the ITA. This is because Mother will have been resident in Canada at some time during the 60 months preceding her death; in the example given, likely during the full 60 months preceding her death.

Although the one daughter will be resident in Canada and will be a beneficiary of the trust, she will be a “successor beneficiary” and thus, she will not be a “resident beneficiary” as those terms are defined in proposed subsection 94(1) of the ITA. In order to be a “successor beneficiary”, the beneficiary must be a beneficiary solely because of the right of that beneficiary to receive any of the income or capital of the trust on or after the death of an individual who is either a “contributor” to the trust or is related to a “contributor” to the trust.

The daughter resident in the U.S. and her children are related to Mother, the sole “contributor” to the trust or would be so related if Mother were still alive. Paragraph (c) of the definition of “successor beneficiary” makes it clear that in determining whether persons are related for the purpose of that definition, the relationship is determined on the basis that no death has occurred. For example, if we were to change the facts in the question such that:

- Mother was alive and had established the trust as a long term resident of the U.S. such that she was not a “resident contributor” to the trust;
- primarily for the daughter and her husband who were also resident in the U.S.;
- with the daughter resident in Canada entitled to benefits from the trust only if both the daughter and her husband in the U.S. were deceased; and
- the daughter living in the U.S. were to die;

The husband who survived her would be considered related to Mother for the purpose of the definition of “successor beneficiary” even though he would no longer be related to Mother for any other purpose of the ITA.

Thus, in the situation described in the question, the trust will have neither a “resident contributor” nor a “resident beneficiary” during the time following Mother’s death and before the death, or immigration to Canada, of any of the beneficiaries currently resident in the U.S.

The daughter resident in Canada will continue to be a “successor beneficiary” until the death of all the other beneficiaries of the trust as described in the question, at which time she will be entitled to income and capital of the trust. At that time, she will become a “resident beneficiary” of the trust as defined in proposed subsection 94(1) and the trust will be deemed resident in Canada by reason of subsection 94(3) of the ITA.

Since the trust will be deemed resident in Canada at that time for the purposes listed in proposed subsection 94(3), including the definition of “specified interest” in proposed subsection 94.1(1) of the ITA, the trust will not be a non-resident entity for the purpose of determining whether the daughter resident in Canada has a participating interest an a foreign investment entity at that time.

Question No. 11: Draft NRT/FIE Legislation

In the event that Bill C-33 is not passed before the filing dates for the 2007 taxation year, is it still the CRA’s view that taxpayers should file in accordance with the proposed legislation? In particular, can immigrant taxpayers who contributed property to a trust that is not resident in Canada in circumstances where the conditions in subsection 75(2) are met continue to rely on proposed paragraph 75(3)(c.2) of the ITA to exclude the income earned by that trust from their income? What is required of taxpayers who have previously filed tax returns in accordance with draft legislation when the effective date was for taxation years after 2002?

CRA Response:

Proposed legislation regarding Non-Resident Trusts (“NRTs”) and Foreign Investment Entities (“FIEs”) was recently introduced in Parliament and is included in Bill C-33 which received second reading in the House of Commons on May 14, 2007. The provisions are generally applicable for tax years that begin after 2006. It is the CRA’s longstanding practice to ask taxpayers to file on the basis of proposed legislation. Consequently, even if the legislation does not receive Royal Assent by the filing due dates for 2007, taxpayers will be expected to file their 2007 returns on the basis of that proposed legislation.

One exception to the general application dates of the NRT and FIE legislation in Bill C-33 relates to proposed paragraph 75(3)(c.2) of the ITA. Under proposed paragraph 75(3)(c.2), subsection 75(2) of the ITA will not apply to a NRT until the contributor has been resident in Canada for more than 60 months. It is proposed that new paragraph 75(3)(c.2) of the ITA will be effective for trust tax years that begin after 2000. Given our position with respect to filing on the basis of proposed legislation, taxpayers to whom income is excluded from income based on proposed paragraph 75(3)(c.2) of the ITA may continue to file their tax returns on the basis of the proposed legislation.

Taxpayers who filed in earlier years, when the effective date of the proposed NRT and FIE legislation was expected to be applicable for tax years beginning after 2002, will need to determine the impact of the change to the coming into force provisions. For trusts created in 2001 or subsequent taxation years, the trust may elect to have the proposed rules apply from the date the trust was created. If the trust has filed based the proposed legislation and intends to elect, no further action is required. Additionally, as there is no change to the proposed implementation date for proposed paragraph 75(3)(c.2) of the ITA no action is required at this time for taxpayers who have filed based on this proposal. If adjustment requests are required, taxpayers should write to the CRA as soon as possible. Adjustment requests for NRTs should be sent to the International Tax Services Office and adjustment requests for FIEs should be sent to the local tax office where the taxpayer lives.

Procedures will be posted on the CRA's website.

Question No. 12: Change of Trustees and Control

In May of 2005, the CRA issued a technical interpretation (2004-0087761E5) that may have widespread implications for corporations that have trusts as shareholders. The technical interpretation dealt with the question of whether there is an acquisition of control of a corporation on the replacement of one or more of three trustees of an inter vivos trust which holds the majority of shares in the corporation. The CRA said that a change in any of the trustees of the trust would generally result in a new group of persons controlling the corporation, even if there is no change in beneficial ownership. The CRA further commented on its position in Income Tax Technical News No. 34, wherein the CRA acknowledged that the possibility of an acquisition of control of a corporation where there has been no change in beneficial ownership presents a policy issue.

Can the CRA advise if there have been any further developments on this issue?

CRA Response:

As indicated in *Income Tax Technical News* No. 34 ("ITTN #34"), we have raised the issue with the Department of Finance and Finance recognizes that there is a problem. There have been no further developments on this particular issue, although other related issues have been brought to our attention in technical opinion requests, including, for example:

(1) whether a Canadian-controlled private corporation ("CCPC") retains its status as a CCPC on the death of an individual where a subsidiary of a public company is the executor of the individual's estate (i.e., a reconsideration of the administrative position set out in the addendum to our response to question 25 of the 1980 Canadian Tax Foundation Round Table); and

(2) whether a corporation that is a subsidiary of a publicly traded income fund with Canadian resident individuals or private corporations as the trustees can qualify as a CCPC.

These issues are currently under consideration by our Directorate and we anticipate having discussions with the Department of Finance before we respond to the technical interpretation requests.

ITTN #34 also comments on the position set out in paragraph 10 of IT-302R3, which indicates that control of a corporation will be regarded as remaining unchanged where the executor, administrator or trustee of an estate is replaced as a result of that person's death or inability to fulfill his or her functions.

Specifically, we advised that: (1) the interpretation bulletin position was first adopted when a previous version of paragraph 256(7)(a) of the ITA provided a legal basis for the position; (2) a 1994 amendment to paragraph 256(7)(a) of the ITA had removed the legal basis for the position; (3) the bulletin position cannot therefore be extended to *inter vivos* trusts; and (4) consideration will have to be given to withdrawing the current bulletin position when the bulletin is next revised.

The CRA has been asked whether the bulletin position may be relied upon in the specific scenario described therein - that control of a corporation will be regarded as remaining unchanged where the executor, administrator or trustee of an estate is replaced as a result of that person's death or inability to fulfill his or her functions.

The ITTN #34 statement that consideration will have to be given to withdrawing the current bulletin position when the bulletin is next revised means that the bulletin position may be relied upon until there is a formal retraction of paragraph 10 of IT-302R3 or a revised bulletin is published.

Question No. 13: Application of 55(2) and GRIP calculation

If applicable, subsection 55(2) of the ITA will deem an otherwise tax-free intercorporate dividend received by a corporation to not be a dividend received by the corporation (see paragraph 55(2)(a)). If the payer corporation had designated the dividend to be an "eligible dividend" pursuant to subsection 89(14), the recipient (assuming the recipient is a Canadian-controlled private corporation) would have included the eligible dividend into its general rate income pool ("GRIP") pursuant to element "G" of the definition of GRIP in subsection 89(1) of the ITA. Given the language in paragraph 55(2)(a), it would appear that the recipient corporation will not have an addition to its GRIP but the payer's GRIP would be depleted (see element "I" of the definition of GRIP in subsection 89(1)).

If our understanding is correct, this would appear to be a permanent depletion of GRIP in circumstances where subsection 55(2) of the ITA would apply. Can the CRA confirm our understanding.

CRA Response:

When a Canadian-controlled private corporation ("CCPC") designates a dividend it pays to its shareholders to be an eligible dividend pursuant to subsection 89(14) of the ITA, the GRIP of the payer CCPC would effectively be reduced permanently. This is so because element I of the definition of GRIP in subsection 89(1) of the ITA stipulates that the amount of any eligible dividend paid by a corporation in its preceding taxation year must be deducted in the computation of its GRIP. In fact, the tax treatment of the dividend to the recipient CCPC has no bearing on the computation of the GRIP of the payer CCPC.

As far as the CCPC recipient is concerned, the CRA would generally accept that the recipient CCPC adds to its GRIP the part of the dividend that is covered by safe income (the "safe dividend"), provided that the CCPC recipient made or makes a designation under paragraph 55(5)(f) of the ITA in order that the safe dividend be considered a separate taxable dividend.

Question No. 14: Listed For Trading

The phrase "listed for trading on a prescribed stock exchange" is used many times in the *Income Tax Act* and Regulations. For instance, an RRSP which wishes to purchases shares must ensure that they are "listed" so they are eligible investments. However, if an RRSP buys shares in an IPO, how will the taxpayer determine if the shares are listed? Please note that the Regulations include a definition of "publicly traded."

CRA Response

While it is a question of fact as to when shares are listed on a stock exchange, we have had a longstanding position (see CRA document 9627665) that shares will be regarded as being listed on a stock exchange so long as a full listing (i.e., an unqualified listing prior to the date set for the shares to be called for trading of the shares) exists. Shares that are conditionally listed will not be listed until the time at which all of the conditions for their listing have been satisfied. We are considering this position in conjunction with an advance income tax ruling request in progress for an income trust.

Addendum

In the situation submitted for an advance income tax ruling, all requirements to be listed on the exchange were met on a particular day ("day 30") and the securities were to commence trading at the opening of business on a subsequent day ("day 35"). Before the opening of business on day 35, however, a delay was announced by the intended issuer. Subsequently, the exchange was not prepared to confirm that the securities were listed on day 30 and consequently, we did not accept that the securities were listed on day 30.

Question No. 15: Pending amendments to OBCA

Ontario has recently passed amendments to many of its corporate and commercial statutes (see Bill 152). Included in this Bill are many amendments to the Ontario *Business Corporations Act*. One in particular affects the nature of shares.

Amendments are pending to section 22 (the effective date of most of these changes is August 1, 2007). A new subsection 22(7) will provide:

"The articles may provide that two or more classes of shares or two or more series within a class of shares may have the same rights, privileges, restrictions and conditions."

The government consultation document accompanying the bill stated that the rationale for this change was to eliminate the need to create artificial distinctions between different classes of shares to ensure that the different share classes are not disregarded.

The concept of distinguishing classes of shares has been considered several times in Canadian tax courts. The judicial consensus (shared by most practitioners) seems to be that there must be some difference between the terms and conditions of different classes or series shares to establish their distinctiveness. See for instance, the FCTD decision in *Champ* 83 DTC 5029; [1983] CTC 1; *McClurg* and *Neuman*.

How will CRA now interpret subsection 56(2) and similar provisions? It would appear that these OBCA amendments statutorily overrule the decision in *Champ*. Will CRA accept that shares can be different just by giving them different names?

CRA Response:

The pending amendment contained in new subsection 22(7) would appear to sanction, to the extent not already regarded as valid, the creation of separate classes of shares that each have the same rights, privileges, restrictions and conditions, including the right to have dividends declared on one particular class of such shares to the exclusion of one or more other class(es) of shares. Such a feature attaching to a number of classes of shares has been considered by our courts on past occasions in connection with the taxation of a disproportionate amount of dividends declared in favour of the holders of one such class of shares.

Consistent with the Supreme Court of Canada's decision in *Neuman* v. *The Queen* (98 DTC 6297 (SCC)), paragraph 9 of Interpretation Bulletin IT-335R2 provides as follows:

> Absent a sham, subterfuge or an artificial transaction and provided that proper consideration was given for the shares when issued, subsection 56(2) does not generally apply to dividend income since, until a dividend is declared, the profits belong to the corporation as retained earnings. However, subsection 56(2) may be applicable where dividends are paid to shareholders of a corporation who, having regard to the dividend entitlements of their shares as set out in the articles of incorporation, receive dividends to which they are not entitled and/or where another taxpayer has a pre-existing entitlement to the dividend income paid to shareholders of a corporation.

Whether a taxpayer has a pre-existing entitlement to a dividend can only be determined on a review of all of the relevant circumstances of a particular situation. This determination will not turn solely on whether the shares in question are of one class or more than one class. For example, it is our view that the pending amendment would not alter the decision in *Champ* (*supra*) which applied subsection 56(2) in the situation where dividends were only declared on one class of shares even though other classes of shares were entitled to share in those dividends proportionately.

The resolution of other income tax issues that may be affected by the recognition of more than one class of shares that have identical rights, privileges, restrictions and conditions (*e.g.*, calculations of adjusted cost base or paid-up capital) will also depend on the facts and circumstances of the particular situation, including the interpretation that may be given to the pending amendment by a court of competent jurisdiction. In this context, it is generally accepted that “tax law embraces corporate law principles unless such principles are specifically set aside by the taxing statute” (Iacobucci J, in *Neuman* v. *The Queen*, *supra*, at 6304).

Question No 16: Follow-Up to 2005 Auditor-General Report on Trusts

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. That report contained a number of recommendations to the CRA, including:

a. requiring trusts to submit a statement of assets and liabilities with their trust returns;

b. evaluating the tax risks in domestic trusts when it selects trusts for review; and

c. ensuring that there is proper reporting of trust income allocated to beneficiaries on information slips.

What steps has the CRA taken in addressing the comments of the Auditor General in the November 2005 report?

CRA Response:

Further to our response at the 2006 STEP Conference the CRA is still in the process of identifying the nature and extent of non-compliance issues related to trusts, considering options to ensure proper reporting of income and analysing the impact of requiring trusts to include a statement of assets and liabilities with the T3 *Trust Income Tax and Information Return*. We continue to meet with internal stakeholders to assess the usefulness of a statement of assets and liabilities, the extent of the burden that this requirement would have on taxpayers and the CRA, and the value of imposing different requirements for different types of trusts. The analysis and consultations are still ongoing.

In the context of this question, we have been asked to bring to your attention an issue concerning the T3 *Trust Income Tax and Information Return*. Over the last few years, CRA has been receiving T3 Summary and related Information Slips without the related Income Tax Return portion of the Return. We would like to remind the industry that in order for the T3 *Trust Income Tax and Information Return* to be complete and filed in the prescribed manner, both the T3 Summary and Income Tax Return are required to be filed.

Question No. 17 Interest Deductibility: *Lipson* and *Singleton*

Two recent cases seem directly opposed. Can you give us any indication how the CRA plans to reconcile Lipson and Singleton?

CRA Response

Paragraph 13 of IT-533 states that it is the direct use of the borrowed funds that generally determines the whether interest will be deductible. That paragraph quotes the *Singleton* case, among others, as support for that conclusion. In *Singleton*, the application of GAAR was not considered.

In *Lipson*, the Federal Court of Appeal found that the Tax Court was entitled to consider the transactions as a whole and their overall purpose in the GAAR misuse and abuse analysis. The Tax Court found as a fact that the transactions formed part of a series, the purpose of which was to make mortgage interest deductible. The Federal Court of Appeal saw no reason to interfere with that decision. *Lipson* has been appealed to the Supreme Court though there has not been an announcement as to whether the Supreme Court will hear the appeal.

Many practitioners believe that the outcome in *Lipson* cast doubt on the position set out in paragraph 13 of IT-533 to the effect that a taxpayer may restructure borrowings and ownership of assets to meet the direct use test.

The CRA will be considering the impact of the *Lipson* decision on the position set out in paragraph 13 of IT-533 and our conclusions will be published in an upcoming *Income Tax Technical News*. In the interim, if you have specific proposed transactions we recommend that you request an advance income tax ruling.

Question No. 18: Partnership Estate Freezes

Would you please update us on the rulings policy for estate freezes carried out through a partnership. Specifically, does CRA accept that a freeze-type arrangement may be carried out through a partnership where a person transfers property to a partnership in exchange for a "preferred partnership unit" with attributes similar to preferred shares as would be used in a corporate estate freeze. In such circumstances, please outline CRA's position as to whether section 103 of the ITA would be applied to reallocate income of the partnership and also whether subsection 56(2) of the ITA would potentially be applicable.

CRA Response:

As stated in *Income Tax Technical News* No. 30, dated May 31, 2004, in our view, there is no impediment to the creation of partnership interests that carry different entitlements to share in the income, loss or other attributes of the partnership. However, the sharing of these tax attributes is subject to section 103 of the ITA. In considering the application of section 103 of the ITA, we would examine whether one of the principal reasons for the separate interests was the reduction or postponement of tax, or in the case where two or more members of the partnership are not dealing with each other at arm's length, whether the amount of income or loss allocated to the unit is reasonable having regard to the circumstances, including capital invested and work performed.

With respect to the potential application of subsection 56(2) of the ITA, in our view, section 103 would be the more specific legislation applicable to partnerships and so the potential application of subsection 56(2) has never been raised as an issue.

In order to provide any definitive comments on a particular arrangement whereby a partnership is used in an estate freeze, and on whether subsections 56(2), 103(1) or 103(1.1) of the ITA 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.

Question No. 19: Acquisition of Control following *La Survivance*

Can you comment on the timing of an acquisition of control under subsection 256(9) of the ITA following the Federal Court of Appeal decision in *La Survivance* v. *The Queen*, 2006 DTC 6288 (FCA)?

CRA Response:

In this case, the Federal Court of Appeal had to determine whether La Survivance, a corporation deemed to be a public corporation, was eligible to claim a "business investment loss" (BIL) under paragraph 39(1)(c) of the ITA following its disposal of the shares of its subsidiary, Les Clairvoyants, in favour of the Société Nationale. The Federal Court of Appeal stated that the presumption in subsection 256(9) of the ITA to the effect that the control of a corporation is, in certain circumstances, deemed to have been acquired at the commencement of that day of that transaction, applies to all of the *Income Tax Act*.

The CRA accepts the Federal Court of Appeal's conclusions in the case of *La Survivance* in regards to the application of the presumption in subsection 256(9) of the ITA. The CRA has decided not to seek leave to appeal of the decision of the Federal Court of Appeal before the Supreme Court of Canada in the case of *La Survivance*, on the ground that this decision does not raise any question of national impact.

However, it seems that, in this case, the concept of "control in fact", as per its meaning in subsection 256(5.1), appears not to have been considered in the determination of whether La Survivance was eligible to a BIL under subparagraph 39(1)(c)(iii) of the ITA. To this end, in order to determine if a capital loss incurred by a taxpayer, resulting from the disposition of shares of a corporation, qualifies as a BIL, the shares so disposed have to be shares of a "small business corporation" (SBC) as defined under subsection 248(1) of the ITA. The definition of SBC provides, *inter alia*, that to qualify as a SBC a corporation has to be a Canadian-controlled private corporation (CCPC) as defined under subsection 125(7) of the ITA. Finally, to be a CCPC, a corporation has, amongst other things, to be a private corporation and a Canadian corporation but cannot be a "corporation controlled, directly or indirectly in any manner whatever", pursuant to subsection 256(5.1) of the ITA, by one or more public corporations.

Accordingly, we are of the opinion that it could be argued that La Survivance "controlled directly or indirectly in any manner whatever" Les Clairvoyants until such time as, during business hours on July 5, 1994, it divested itself of the shares in Les Clairvoyants in favour of the Société Nationale, notwithstanding the presumption in subsection 256(9). The corporation Les Clairvoyants not being a CCPC, we would have expected that La Survivance would not have had the right to claim a BIL in regard to the disposition of the shares of Les Clairvoyants.

Therefore, the CRA plans to assess similar cases to La Survivance's in order to disallow any BIL claimed.