2008 STEP National Conference
Question 1 – Critical Illness Insurance

Where a corporation owns critical illness insurance which provides coverage to a shareholder/employee, what is the CRA's position regarding subsection 15(1) benefits?

Is CRA's position different where the underlying critical illness insurance policy has a return of premiums provision?

Response

A benefit provided to an individual who is a shareholder of a corporation will give rise to a shareholder benefit pursuant to subsection 15(1).

When a benefit is provided to an individual who is both an employee and a shareholder of a corporation, the capacity in which he or she receives that benefit is always a question of fact to be decided based on the particular circumstances. In response to Question 13, posed at the 2006 *Conference for Advanced Life Underwriting*, we opined in CRA Document 2006-0174121C6 that, "In and by itself, the fact that an individual is the only employee and shareholder of a corporation does not mean a benefit is received qua shareholder. We agree that a pragmatic approach to the determination is warranted and, generally, if it is reasonable to conclude that the benefit has been provided as part of a reasonable employee remuneration package we will consider it to be received qua employee." It remains our view that a reasonable and pragmatic approach to benefit determination is acceptable in a shareholder/employee situation. Accordingly, where it has been factually determined that a shareholder has received critical illness insurance coverage in his or her capacity as a shareholder, a benefit in respect of such coverage arises under subsection 15(1).

With respect to the inclusion of a "return of premiums" provision in a critical illness insurance policy, as noted in CRA Document 2003-0054571E5, the presence of a "return of premiums on expiry" provision that provides for a benefit that is solely a return of paid-in premiums is unlikely, in and of itself, to result in the critical illness insurance policy being viewed as having a different character for purposes of the Act. As such, in a situation in which it has been determined that the coverage is provided qua shareholder, the CRA position would be that the provision of a critical illness insurance policy that has a return of premiums benefit gives rise to a shareholder benefit under subsection 15(1).

2008 STEP National Conference
Question 2 - Use of a Joint Last-to-Die Policy to settle a testamentary trust

Life insurance policies have many uses in estate and financial planning. One use of life insurance proceeds is to settle a trust for the benefit of children or grandchildren. The CRA has confirmed in the past (CRA Document 9605575) that a trust settled with life insurance proceeds can qualify as a testamentary trust.

The question has arisen as to how a joint last-to-die policy would be treated where the policy is jointly owned by a husband and wife (or common-law partners). Where a policy is jointly owned, it must be dealt with jointly meaning that two signatures are required in respect of policy transactions, including beneficiary designations.

However, after one spouse dies and the other spouse becomes the sole owner of the policy (that is, the policy passed to the surviving spouse by right of survivorship), that spouse could change the beneficiary designation.

In the CRA's view, would a trust settled with the proceeds of a jointly owned last-to-die life insurance policy qualify as a "testamentary trust", as defined in subsection 108(1) if the trust was designated by the spouses jointly and the surviving spouse makes no change to the designation? Assume the trust is settled in the same manner as that set out in the above noted technical interpretation.

Response

A testamentary trust is a trust that arises on and as a consequence of the death of an individual with certain exceptions. One of these exceptions is a trust created after November 12, 1981 if, before the end of the taxation year, property has been contributed to the trust otherwise than by an individual on or after the individual's death and as a consequence thereof.

As previously stated by the CRA at this conference and in other technical interpretations issued by the CRA, a trust created pursuant to the individual's will or other testamentary instrument will not lose its testamentary trust status solely by reason of the receipt of the proceeds of an insurance policy on the life of that individual (who was the policyholder), where the trust is the designated beneficiary under the policy and the trust was not created or settled before the death of the individual.

In the case of a joint last-to-die life insurance policy where the only amount that is payable to the trust under the policy is paid on the death of the last of the two persons insured under the policy, our position would be the same - that is, a trust created from the receipt of the proceeds of such a policy will not lose its testamentary trust status solely by reason of the receipt of the proceeds of that insurance policy provided that the life insurance policy is owned by the individual who survives the other immediately before his or her death and the policy qualifies as a testamentary instrument of that person at that time.

2008 STEP National Conference
Question 3 - Trustee and Executor Fees

We seek clarification of CRA's position on the deductibility of Trustee and Executor fees. Consider the following scenarios:

a. An estate or trust owns several rental properties. These properties generate income, but require the attention of one or more of the trustees to ensure proper maintenance, collection of rental revenue, etc. Are fees payable to the trustees or executors deductible in computing the income of the trust? Does the answer change if the trustee receiving the fee is a corporate trustee?

b. The trust has a large investment portfolio. There are several discretionary beneficiaries, with different cash flow needs. For instance, there are some minor children for whom the trustees have invested a portion of the portfolio for capital appreciation. There is another beneficiary who is handicapped and who requires cash flow on a regular basis to meet medical and related expenses. For this beneficiary the trustees have created a segregated portfolio of dividend paying securities and income generating debt instruments. The trustees have not delegated their investment decisions to a third party but undertake them on their own. Are fees payable to the trustees deductible?

c. The trust has a recreational property as well as a portfolio of securities which generate income. The role of the trustees is to ensure that property taxes on the recreational property are paid and that the property is maintained for the benefit of all beneficiaries. Are fees payable to the trustees deductible?

d. The same as case (c) above, but the trustees have the power to sell the property and to reinvest the sale proceeds. The trustees have received an offer which is too good to refuse, and they propose to sell the property. Are the fees payable to the trustee deductible? If not, could the fees payable to the trustees be considered one of the expenses of disposition of the property and therefore indirectly deductible?

Response

There is no specific legislation in the Act that addresses the deductibility of trustee fees in computing the income of a trust or estate. Trustee fees are deductible when they meet the usual criteria necessary to be deductible in computing income from business or property. That is, where they are "made or incurred for the purpose of gaining or producing income from the business or property", "not an outlay...on account of capital" and are "reasonable in the circumstances", the amounts will not be denied by reason of paragraph 18(1)(a), paragraph 18(1)(b) or section 67, respectively. In addition, paragraph 20(1)(bb) provides a deduction for investment counseling advice in the circumstances described in that provision even though, in the case of a trustee administering shares or securities, all or part of the fees may have been charged to the capital account of the trust. It should be noted that fees paid to create a trust, to gather or distribute trust assets, or to wind up a trust, are normally on account of capital and, therefore, not deductible in computing income.

A trustee or executor will often perform a mixture of duties, only some of which relate to the earning of income from a business or property. In the Walmsley Estate (1999 DTC 594) case, the executor failed to provide a breakdown as to what portion of his fees related to the various duties imposed on him as executor and as a result, the CRA reassessment was upheld. Note that in determining what portion of the trustee fees relates to the duties of earning income from business or property, it would be relevant to consider the amount, if any, paid out of the trust property by the trustee or executor to another person to perform the same duties.

With respect to the first example, the issue is what portion of the fees pertains to the duties of earning income from the rental property. It is a question of fact as to what portion of the fees charged by the trustee relate specifically to the duties that relate to earning income from the rental property and is reasonable in the circumstances.

The same issue arises with respect to the second example involving a trust that holds a portfolio of investments. In determining what portion if any of the trustee fees are incurred to earn income from property, it should be noted that the Courts have held that the fees charged for administering the trust property – for reviewing the trust's property, analyzing the stock market and making decisions in respect of the purchase or sale of trust property – is not an expense incurred to earn income from a business or property and is therefore prohibited as a deduction by reason of paragraph 18(1)(a). Thus, the portion of the trustee fees that relates to overseeing the management of the investment portfolio will only be deductible if the fees related to such duties meet the criteria in paragraph 20(1)(bb). This will only occur if, among other things, the trustee's principal business is advising others on the advisability of purchasing or selling specific shares or services related to the administration or management of shares and securities.

With respect to the third example concerning the recreational property, as indicated in the comments on trustee fees found in the *T3 Trust Guide*, fees pertaining to the maintenance of the recreational property for the use of the beneficiaries are not deductible in computing the trust's income because they are not incurred for the purpose of earning income from a business or property. However, subsection 104(6) permits a deduction for amounts included in computing the income of a beneficiary under subsection 105(2). Subsection 105(2) provides that a reasonable portion of amounts paid out of the income of a trust for the upkeep of property maintained under the terms of the trust arrangement for the use of a life tenant or other beneficiary is required to be included in the income of the life tenant or other beneficiary for the taxation year for which the amounts were paid. If there is no income and thus no amounts paid out of income for maintenance, then no amount would be deductible (CRA Document 2005-0141481E5).

With respect to the treatment of the trustee fees as part of the cost of the property or as an outlay or expense incurred for the purpose of the disposition, this issue was raised in the case of the Currie Estate (2004 DTC 2346). While the Court acknowledged that certain expenditures incurred by the estate might possibly come within the purview of subparagraph 40(1)(a)(i) as an outlay or expense incurred for the purpose of the disposition, the evidence was insufficient in that particular case to establish that any portion of the amount so claimed, including the fees paid to the administrator of the estate, was incurred for the purpose of the acquisition or disposition of the property. In our view, it is difficult to see how any portion of the trustee fees could be considered to be an outlay or expense incurred for the purpose of a particular disposition since the amount of the fees payable to the trustee is generally fixed without reference to whether any particular trust property is sold or not. Moreover, there is no provision in subsection 53(1) that would allow any portion of the trustee fees to be added the cost of the property.

You also raised the issue of any potential difference in approach with respect to fees charged by a corporate trustee and fees charged by an individual trustee. While there is no fundamental difference in the analysis based on whether the trustee is an individual or a corporation, the comments made at the Revenue Canada Round Table” in *Report of the Proceedings of the Thirty-Third Tax Conference*, 1981 Conference Report on this issue are still relevant. While it is not correct to say that fees paid to individuals can never be categorized as amounts paid to a person whose principal business is advising on the purchasing or selling of securities or for services with respect to administration and management of shares or securities, a deduction under paragraph 20(1)(bb) will only be allowed if the conditions set out in that paragraph are met as explained in IT-238R2, *Fees Paid to Investment Counsel*.

2008 STEP National Conference
Question 4 - Subsection 75(2) and the CCA limitation

When subsection 75(2) applies to attribute income from rental property to an individual and that individual receives income from rental property owned directly, is the CCA limitation in subsection 1100(11) of the Regulations based on the net rental income included in the individual's income or is the CCA limitation for the trust's rental property computed separately from the CCA limitation for the individual's rental property?

Response

The CCA limitation in subsection 1100(11) of the Regulations is imposed on each taxpayer separately. Subject to certain exceptions that are not relevant to the question, subsection 1100(11) of the Regulations limits the amount of CCA that can be claimed by certain taxpayers in respect of rental property to the amount determined under that subsection. In particular, the CCA claimed in a particular taxation year cannot exceed the aggregate of the rental income earned in that year from properties owned by the taxpayer, either alone or as a member of a partnership in excess of the rental losses in respect of the same category of properties. As the individual does not own the property held by the trust, it is our view that the CCA that can by claimed by the individual is limited to the net rental income in excess of rental losses from properties owned by that individual, either alone or as a member of a partnership. Likewise, in computing the amount of income to be attributed to the individual under subsection 75(2), the trust would be entitled to claim CCA to the extent permitted by the Regulations – that is, the amount would be limited to the amount of rental income in excess of rental losses from properties owned by the trust, either alone or as a member of a partnership.

Consider the following examples. In the first one, the trust has a net rental loss of $35,000 and the individual has net rental income, before CCA, of $25,000. If the CCA limitation is limited by the net rental income before CCA that will be included in the individual's income, no CCA could be claimed by the individual or the trust since the rental losses exceeds the rental income. On the other hand, if the CCA limitation is applied to each taxpayer, the trust and the individual, separately, the individual would be able to claim CCA of $25,000, assuming the UCC of his or her buildings is high enough and as expected, no CCA could be claimed in respect of the properties owned by the trust. Since subsection 1100(11) of the Regulations applies to each taxpayer separately, the individual is able to claim CCA of $25,000 provided that the UCC of his rental property is high enough.

In the second example, the trust has a net rental income, before CCA of $40,000 and the individual has net rental loss of $10,000. If the CCA limitation is limited by the net rental income before CCA that will be included in the individual's income, the combined CCA on the individual's and trust's properties, assuming the UCC is high enough, would be limited to $30,000. On the other hand, if the CCA limitation is applied to each taxpayer separately, the CCA that could be claimed in respect of the properties owned by the trust would be limited to $40,000, assuming the UCC of the trust's buildings is high enough, but the individual would not be able to claim any CCA in respect of his or her own properties. Since subsection 1100(11) of the Regulations applies separately to each taxpayer, the trust is able to claim CCA of $40,000 provided that the UCC of its rental properties is high enough and the net amount of its income would then be attributed to the individual.

2008 STEP Conference
Question 5- Estate Planning

An individual has heard that probate taxes on his or her principal residence can be avoided if the property is transferred to adult child while the individual is still alive. Two methods have been suggested:

- the transfer of property into joint ownership with the adult child while the parent is still alive;

or

- the transfer of the remainder interest in the property to the adult child with the parent retaining the life interest.

Can the CRA comment on either of these options?

Response

While the CRA cannot comment on the effectiveness of either transaction for the purpose of provincial estate planning, we have commented on the federal income tax consequences of each option in documents such as CRA Documents 2005-0152011E5 and 2007-0242921E5.

With respect to the transfer of property into joint tenancy with the adult child, the first issue to consider is whether there has been a change in beneficial ownership at that time. Obviously, it is a question of fact in any particular situation as to when and whether the beneficial ownership of property changes as a result of the change in legal title.

In the situation where beneficial ownership changes as a result of the transfer of the property from sole ownership into joint tenancy between the parent and child, the parent realizes a disposition of 50% of his or her interest at that time and would presumably be able to shelter any capital gain arising as a result of such a disposition with the principal residence exemption. Paragraph 69(1)(c) provides that property acquired by way of gift would be deemed to have been acquired at its fair market value. Thus, the child would acquire a 50% interest in the property at that time at a cost equal to parent’s deemed proceeds of disposition. Upon the death of the parent, the parent would be deemed to have disposed of the parent’s remaining 50% interest in the property for proceeds of disposition equal to its fair market value immediately before the death. As with the earlier disposition, the parent’s capital gain resulting from the deemed disposition under paragraph 70(5)(a) would generally be expected to be exempt from tax by reason of the principal residence exemption under paragraph 40(2)(b) provided that the parent continued to reside in the property until death and otherwise met the conditions necessary for the property to qualify as the parent’s principal residence. Pursuant to paragraph 70(5)(b), the child, as the sole surviving joint owner, would be deemed to have acquired the additional 50% interest in the property at a cost equal to the parent’s deemed proceeds of disposition. Therefore, the child’s total cost of the property would be equal to the sum of the fair market value of the 50% interest acquired when the ownership of the property was transferred into joint tenancy and the fair market value of the 50% interest acquired upon the death of the parent.

If, as has been suggested in some of the letters we received, the beneficial ownership does not change when the property is transferred into joint ownership between the parent and child, no disposition will occur for tax purposes on the transfer of the legal title to the property into joint ownership between the parent and child. In that situation, a true joint tenancy arrangement would presumably not exist and, for tax purposes the child would acquire no interest in the property at that time. Upon the death of the parent, the parent would be deemed to have disposed of his 100% interest in the property immediately before the death for proceeds of disposition equal to its fair market value at that time and the child would be deemed to have acquired the property for the same amount.

When a parent disposes of the remainder interest in the property to his or her child, while retaining the life estate, subsection 43.1(1) applies with the result that the parent is deemed to have disposed of his or her life estate in the property for proceeds of disposition equal to its fair market value at that time. As a result, the parent recognizes any gain accrued on the entire property at the time the remainder interest is given to the child– that is, the parent has actually disposed of the remainder interest to the child, presumably by way of gift and is deemed to have disposed of the life interest. However, as in the examples mentioned above, the parent would presumably be entitled to shelter any capital gain so realized with the principal residence exemption. The cost of the child's remainder interest in the property, as determined under paragraph 69(1)(c), is expected to be the fair market value of the property at that time less the fair market value of the life interest retained by the parent.

Upon the death of the parent holding the life interest in the property and the resulting expiry of the life interest, subsection 43.1(2) states that the parent who held the life interest is deemed to have disposed of it at its adjusted cost base and this amount is typically added to the cost amount of the remainder interest held by the child by reason of paragraph 43.1(2)(b). The exact amount of the addition to the child's adjusted cost base of the property is the lesser of the parent's adjusted cost base of the life interest, and the amount, if any, by which the fair market value of the property immediately after death exceeds the adjusted cost base of the remainder interest.

The application of subsection 43.1(2) can best be explained with an example:
If a mother transfers the remainder interest in her principal residence to her son when the value of the property is $300,000 and the value of the life interest is $200,000, the mother would have a deemed disposition of her life interest for proceeds of disposition of $200,000 and a disposition of the remainder interest for deemed proceeds of disposition of $100,000, the total of which represents the full fair market value of the property. The son's cost of the remainder interest at that time would be $100,000. Assuming that the fair market value of the property at the time of the mother's death is $400,000, no further gain would be realized by the mother upon her death, but the cost of the remainder interest to the son would be increased from $100,000 to $300,000 - but not $400,000. Conversely, if the entire property was only worth $250,000 immediately before the mother's death, the cost of the remainder interest to the son would be increased from $100,000 to $250,000. As a result, the son will realize a greater capital gain on the subsequent disposition of the property in the first example than he would if the mother had not transferred a remainder interest to her son while she was living. In the second example where the fair market value of the property has declined below the level at which mother was deemed to have disposed of the property, the son's subsequent gain is the same as it would have been if the son had acquired the property under paragraph 70(5)(b) on the death of the mother.

In the case of *Depedrina et al v. the Queen* (2005 DTC 1386), the adult children acquired their parents' principal residence on the death of their parents as a consequence of their remainder interest in the property. As a result, the capital gain realized by the children on the subsequent sale was greater than it would have been if their cost of the property had been determined under paragraph 70(5)(b). The children tried, unsuccessfully, to argue that their parents had not intended to transfer a remainder interest to them because the parents did not fully appreciate the tax consequences of their actions. The court concluded that the transfer involved the parents getting independent legal advice and that their actions - the giving of the remainder interest – was sufficient to have section 43.1 apply and the Minister's reassessment was upheld.

STEP 2008 National Conference
Question 6 - Foreign Tax Credit of a Deemed Resident Trust

A trust that is deemed resident in Canada under paragraph 94(1)(c) is entitled to a foreign tax credit in respect of the income or profits tax that it has paid to a foreign government in respect of the income that is subject to tax in Canada under paragraph 94(1)(c). However, the definition of non-business income tax in subsection 126(7) is limited, among other things, to the amount that was not deductible under subsection 20(11) or deducted under subsection 20(12). This has the general effect of limiting the amount of a taxpayer's non-business income tax to 15% of the non-business income earned by that entity. Is the foreign tax credit of a deemed resident trust also limited to 15% of the income earned in that other country?

Response

No. Since clause 94(1)(c)(ii)(B) deems the amount of income or profits tax described in that clause to be the amount of the trust's non-business income tax, there is no need to refer to subsection 126(7) in computing the amount of non-business income tax of a trust that is deemed resident in Canada under paragraph 94(1)(c). As a result, a trust that is deemed to be resident in Canada under paragraph 94(1)(c) may claim a foreign tax credit in respect of the full amount computed under clause 94(1)(c)(ii)(B) provided that the amount does not exceed the proportion of the taxpayer's Part I taxes otherwise payable that is attributable to the income described in clause 94(1)(c)(ii)(A).

2008 STEP National Conference
Question 7 –Form T1261

What is the purpose of form T1261? Is it a prescribed form? When must a non-resident taxpayer obtain an individual tax number?

Response

Form T1261, *Application for a Canada Revenue Agency Individual Tax Number (Individual Tax Number) for Non-Residents*, is used to obtain an Individual Tax Number from the CRA. An Individual Tax Number is a nine-digit number issued to individuals who need an identification number but who are not eligible to obtain a Social Insurance Number. An Individual Tax Number begins with 09. Although Form T1261 is not a prescribed form, it outlines the proof of identity and information requirements that must be fulfilled before an Individual Tax Number is issued.

An individual who has immigrated to Canada or become resident in Canada, and who is eligible to receive a Social Insurance Number but has not yet received the Social Insurance Number, can file his or her tax return without a T1261. The CRA will issue a Temporary Tax Number, and will cross-reference the information once the Social Insurance Number is acquired.

Individuals who may need to provide an Individual Tax Number to the CRA include:

- An international student who either has to file or intends to file a Canadian income tax return;
- A non-resident filing an application to waive or reduce Canadian withholding tax;
- A non-resident disposing of taxable Canadian property; or
- A non-resident who has to file or intends to file a Canadian tax return.

Instructions for completing Form T1261 can be found on the back of the form.

Dispositions of a Capital Interest in a Trust Resident in Canada

Question 9 of the 2006 STEP Round Table noted that a payment in satisfaction of all or part of a beneficiary's capital interest in a trust resident in Canada (other than a mutual fund trust in most cases) will give rise to a disposition of taxable Canadian property. Therefore, when a trust resident in Canada distributes one or more of its properties to a non-resident beneficiary in satisfaction of all or part of the beneficiary's capital interest in the trust, the beneficiary will have to obtain an Individual Tax Number, file notice under section 116, and file a return of income.

A number of significant concerns have been raised related to these distributions and the compliance burden imposed on transactions where there may be no tax liability. For this reason, the CRA will waive the requirement to file Form T1261 prior to filing notice under section 116 when a disposition results from a distribution from a personal trust, which includes an estate or testamentary trust, of money or property (other than real property) that would have been considered personal-use property of the settlor or deceased taxpayer. However, the CRA may still request a completed form T1261 when the taxpayer files a return of income in respect of the disposition.

<u>2008 Federal Budget</u>

The 2008 Federal Budget (now Bill C-50) proposes to amend section 116 to remove the requirement to obtain a Certificate of Compliance where the non-resident vendor disposes of property that is “treaty-exempt property”, as defined in new subsection 116(6.1). In addition, Bill C-50 proposes to amend section 150 to remove the requirement for non-resident individuals to file a return of income when they dispose of taxable Canadian property that is in an “excluded disposition”, as defined in new subsection 150(5). These proposals will apply in respect of dispositions that occur after 2008.

For example, assume Alex, a US resident, is the sole beneficiary of the estate of his uncle, who was a resident of Canada. The estate is resident in Canada, and Alex is not related to the executor of the estate. The estate has a calendar year-end. All of the assets of the estate are sold for cash in 2008, and the gains are taxed in the estate. In 2009, the cash is distributed to Alex and the estate is wound up.

Although the disposition of his interest in the estate does not result in a capital gain, Alex’s interest in the estate is taxable Canadian property to him, and the disposition triggers the requirements of section 116. Under current legislation, Alex provides notice to the CRA under section 116 in respect of the disposition, and receives a Certificate of Compliance. Alex also has an obligation to file a T1 return of income.

However, if Bill C-50 is enacted as proposed, Alex will not be required to provide notice to the CRA under section 116 in respect of the disposition, nor will he be required to file a T1 return of income (assuming he has no other amounts payable under the Act for the year or a prior year). Alex’s interest in his uncle’s estate will be “treaty-exempt property” since Alex is resident in the U.S. and the gain (if any) from the disposition of the interest would be exempt from tax under Part I because of the *Canada-U.S. Income Tax Convention*. Furthermore, the estate will not be required to withhold under subsection 116(5) in respect of the distribution to Alex.

2008 STEP National Conference
Question 8 –Foreign Investment Entities and Failsafe Clauses

In December 2007, many trusts with “failsafe” clauses (inserted for trust planning rules, not tax minimization) were amended to comply with changes to the non-resident trust rules. Many of these trusts had no connection to Canada (foreign settlers, foreign trustees, foreign assets and foreign beneficiaries) absent concerns raised by the definition of “specified interest” in the current draft legislation. Some wags suggested that amendments should include as (discretionary or limited (e.g. $10) fixed interest) Canadian beneficiaries any individual (and his or her minor children) who served in the year in the federal cabinet. If such an amendment was made, what would be the Canadian tax implications to the trust (assuming current proposed rules are enacted)?

Response

While the confidentiality provisions of the Act prohibit us from discussing or providing information about any specific taxpayer without his or her written authorization, it may be helpful to clarify how the foreign investment entity rules would apply in the case of a typical failsafe clause. For example, a trust might be established in the US, by a resident of the US, for the benefit of residents of the US who are members of the settlor’s family. In the event of the death of all the existing beneficiaries, the terms of the trust may provide that the residue of the trust will be paid to a relative of one of the existing beneficiaries and that relative could be a resident of Canada.

In such a situation, the resident of Canada entitled to receive the residue of the trust in the event of the death of all the other beneficiaries would presumably be a successor beneficiary as defined in proposed subsection 94(1). A successor beneficiary is defined in proposed subsection 94(1) as a beneficiary whose sole right to receive any of the income or capital of the trust as a beneficiary arises only on or after the death of an individual who has either contributed property to the trust, is related to a person who has contributed property to the trust or would be related to a person who contributed property to the trust if every individual who was alive before that time were alive at that time. Thus, if a father establishes a trust for his wife and three children with the residue payable to his brother in the event that his wife and children die before the trust is wound up, the brother would be a successor beneficiary because the wife and children are related to the father. Proposed paragraph (c) of the definition of successor beneficiary – the paragraph that refers to the relationship of the settlor to others on the assumption that every person who was alive at any time in the past is still alive at the time the definition is being applied - ensures that a particular successor beneficiary will not lose his or her status as a successor beneficiary because of a death. For example, if the beneficiaries of the trust are the adult children of the settlor’s spouse, the adult children will be related to the settlor for the purposes of the Act provided the settlor and the spouse are alive. If either of them dies and the adult children were never adopted by the settlor or were never wholly dependant on the settlor for support, the children will no longer be related to the settlor for the purposes of the Act. However, anyone named as a beneficiary in the event of the death of the adult children will continue to be a successor beneficiary because the children would be related to the settlor if the settlor and spouse were both still alive.

For the purpose of the definition of “specified interest” and “participating interest” in a “non-resident entity” as defined in proposed subsection 94.1(1), an individual who is a successor beneficiary of a particular non-resident trust will not be considered to have a specified interest in that non-resident trust, and as a result, will not have a participating interest in a non-resident entity, provided that the relevant contributor has contributed more than 10% of all the contributions received by the trust.

If the individual entitled to the residue of the trust property under the failsafe clause does not qualify as a successor beneficiary, which would only occur if the person whose death triggers his or her right to receive any of the income or capital of the trust is not related to a person who has contributed more than 10% of all contributions received by the trust, such an individual may have a specified interest in the trust and a participating interest in a non-resident entity depending on the terms and conditions of the trust and the residence of the trust and the individual. While this would not be the case in the type of situation described above, if it were the case and the individual named in the failsafe clause had no reasonable expectation of receiving an amount of any significance from the trust, that individual might well consider disclaiming, releasing or surrendering his or her interest in the trust in order to avoid the need to include any amount in income under the foreign investment entity rules. If the beneficiary is a minor and would be required to include an amount in income under the foreign investment entity rules in respect of an interest in a trust in which the child had little or no reasonable expectation of receiving a distribution, presumably the provincial Public Trustee or Children’s Lawyer would be able to act on behalf of the child.

2008 STEP National Conference
Question 9 – Proposed 94(3) and "Exempt Amounts"

Proposed subparagraph 94(3)(a)(ix) imposes Part XIII tax on a payment from a deemed resident trust to a non-resident beneficiary except where the amount is an "exempt amount" as defined in proposed subsection 94(1). A distribution of income to a non-resident beneficiary will be an exempt amount if, among other things, the trust was created before October 30, 2003 and no contribution has been made to the trust since July 18, 2005. Can you provide any clarification on the meaning of "contribution" for the purposes of this provision? In particular, would any of the following constitute a contribution to the trust for the purposes of proposed subsection 94:

- the payment of an invoice of trust by a beneficiary of the trust, including a non-resident beneficiary; or
- the investment of the trust property in various partnerships and corporations (with the resulting transfer of shares or a partnership interest to the trust) including entities resident in Canada as well as non-resident entities that are not carrying on business in Canada?

Response

We considered this issue in CRA Document 2007-0250731E5. A contribution for this purpose is a "contribution" as defined in proposed subsection 94(1) and excludes a transfer of property that meets the definition of "arm's length transfer" as defined in proposed subsection 94(1).

The payment of a bill or invoice of the deemed resident trust by a beneficiary for no consideration would constitute a "contribution" as defined in proposed subsection 94(1). The legislation provides certainty in this determination because proposed paragraph 94(2)(a) provides that an entity is deemed to have transferred property to the trust in situations where the entity transfers property to a third party and by reason of that transfer, the liability or potential liability of the trust decreases at that time. Since the beneficiary receives nothing in exchange for the payment of the invoice, the transfer is not an arm's length transfer and is thus, a contribution.

With respect to the second item – the investment of the trust property, the CRA document provides a more complete analysis of the issues relating to investment in foreign corporations not carrying on business in Canada that might be made by a trust and for those who are interested, you may wish to consult that document. Let's consider some of the investments that a deemed resident trust might make:

If the trust acquires the shares of a corporation resident in Canada through a stock exchange or other public market, the transfer will likely not form part of a series of transactions under which an entity –any entity - acquires an interest in the trust nor will it involve the acquisition or disposition of restricted property. The purchase price will be set by the public market and will likely meet the condition in (b)(iv) of the definition of "arm's length transfer" – an exchange that would be entered into by arm's length persons having regard only to the transfer and the property received in exchange for it. If the trust invests in a corporation resident in Canada as part of an initial offering by that corporation, the corporation will be considered to have transferred property to the trust by reason of the deeming provision contained in proposed paragraph 94(2)(g).

Whether or not such a transfer results in a "contribution" to a particular trust depends in large part on whether the transfer can be considered to be an "arm's length transfer" as that term is defined in proposed subsection 94(1). If it is considered an arm's length transfer, the Canadian corporation will not be a contributor to the trust. If it is not an arm's length transfer, the Canadian corporation will be a resident contributor to the trust and the transfer will be a contribution for the purpose of the rules in section 94. In order for a particular transfer or loan to qualify as an "arm's length transfer":

- the transfer or loan must not involve the exchange of any "restricted property" as that term is defined in proposed subsection 94(1) either as part of the property transferred or loaned or as part of the property received in exchange for the property transferred or loaned;
- it must be reasonable to conclude that none of the reasons for the transfer is the acquisition by any entity of an interest in the trust; and
- the conditions set out in one of the subparagraphs of (b) of the definition of "arm's length transfer" must be met with respect to the transfer.

While each of the conditions necessary for finding a particular transfer to be an arm's length transfer involves a finding of fact, the purchase of shares as a result of an initial offering to the public will likely not form part of a series of transactions under which an entity acquires an interest in the trust nor will it involve the acquisition or disposition of restricted property. As the offering is open to the public at large, the transfer will likely meet the condition in (b)(iv) of the definition of "arm's length transfer" – an exchange that would be entered into by arm's length persons having regard only to the transfer and the property received in exchange for it.

If on the other hand, the acquisition results from a private sale such as might occur in an estate freeze situation, the transfer is more likely to not meet the condition in (b)(iv) even though the shares are acquired by the trust at fair market value. This is because, in the case of an estate freeze, the terms and conditions are such that one can reasonably expect that the corporation, as transferor, would not have issued the shares to anyone other the trust under the same terms and conditions, having regard only to the issuance of shares and property received in exchange for those shares. In addition, if the shares are acquired as part of an estate freeze, the shares of the corporation will be restricted property as defined in proposed subsection 94(1) and as a result, the transfer will not qualify as an arm's length transfer. The result will be that the Canadian corporation is a resident contributor to the trust and subject to the joint liability provisions and any subsequent distributions of income that are deductible in computing the trust's income will not be exempt amounts as defined in subsection 94(1).

If the shares acquired are shares of a foreign corporation, much of the same analysis applies. To the extent that the acquisition is through a stock exchange or other public market, the transfer will likely not be part of a series of transactions and the transfer itself will presumably meet the definition of arm's length transfer and will not result in a contribution by the foreign corporation or by the seller of the shares. The acquisition of the shares of the foreign corporation as part of an initial offering would result in a transfer to the trust by the foreign corporation by reason of paragraph 94(2)(g). An offering that is open to the public at large will presumably meet the condition in (b)(iv) of the definition of "arm's length transfer". Note that if the acquisition is not an arm's length transfer, the foreign corporation's contribution to the trust will cause future distributions of foreign source income, that is, distributions of income that would be deductible to the trust notwithstanding proposed subsection 104(7.01), to be subject to Part XIII tax even though the foreign corporation will not be a resident contributor to the deemed resident trust.

As a final point, it should be noted that the definition of exempt amount also includes distributions of income that are not deductible in computing the trust's income under subsection 104(7.01) – such distributions can loosely be described as distributions of income from Canadian sources. Thus, the distribution of income to a non-resident beneficiary that is not deductible to the trust by reason of proposed subsection 104(7.01), that is the Canadian source income, will not be subject to Part XIII tax.

2008 STEP National Conference
Question 10 – Liechtenstein Foundation

Is a Liechtenstein foundation a trust or a corporation for the purposes of the Act?

Response

A Liechtenstein foundation is an entity which has legal personality and owns the property transferred by the founder. Since the introduction of IT-343R, *Meaning of the Term Corporation*, in 1977, we have changed our position regarding the significance of the separate legal entity status in the classification of foreign entities. At the time that IT-343R was written in 1977, separate legal entity status was considered a fundamental characteristic of a corporation and essentially defined any entity with its own separate legal existence as a corporation. Today, the situation is quite different and separate legal entity status is no longer considered a distinctive feature of corporations alone. The CRA will generally employ a two-step approach: the first step involves determining the characteristics of the foreign arrangement under the appropriate foreign law, and the second step involves comparing those characteristics with recognized categories of entities under Canadian law for tax purposes. Following the two-step approach, we are of the view that the attributes of a Liechtenstein foundation more closely resemble those of a Canadian trust under our common law than they do that of a corporation.

For example:

- A Liechtenstein foundation is created by an endowment by a founder much like a settlor gifts property to a trust.
- A Liechtenstein foundation can be created during the founder's lifetime or upon the founder's death; similarly, a trust may be created *inter vivos* or by will.
- A Liechtenstein foundation has beneficiaries, just like a trust.
- The beneficiaries, similar to beneficiaries of a trust, may derive a present or future advantage from the assets of the foundation, be it a share in the revenues or a share in the assets of the foundation on the basis of a resolution of the foundation council.
- Much like a personal trust, in a family foundation, the beneficiaries do not pay for their interests and are not entitled to vote.
- The foundation council acts in the same way trustees do to protect the capital of a Liechtenstein foundation and to follow the founder's wishes. The foundation board administers and uses the property transferred by the founder for the benefit and advantage of the beneficiaries. The foundation board exercises considerable decision and control powers over the foundation assets much as a trustee has over the assets of a trust.
- While a Liechtenstein foundation is a separate legal entity, it is unlike a corporation in that a Liechtenstein foundation is a legal entity without members, partners or shareholders. It is also unlike a corporation in that a Liechtenstein foundation cannot perform any commercial activities except when commercial operations serve its non-commercial purpose or the type and scope of the participation held require the facilities of a commercial business whereas a corporation is presumed to be constituted for the purpose of carrying on commercial activities.

In closing, we note that generally speaking, a non-resident trust is only taxable in Canada on its income earned from sources in Canada unless section 94 applies. Thus, the issue of whether a

Liechtenstein foundation is considered a trust for Canadian tax purposes will be of primary relevance when one or more of the beneficiaries of the foundation are resident in Canada or when the founder is, or has been, resident in Canada.

2008 STEP National Conference
Question 11 –Tax Treaties

What is CRA's view of international tax treaties and the GAAR in light of the recent decision in MIL?

Response

Our approach to the interpretation and application of our tax treaties was not affected by the decision in *The Queen v. M.I.L (Investments) S.A.*, 2007 DTC 5437. With respect to treaty shopping generally, the CRA will scrutinize all such arrangements to ensure that the entity claiming treaty benefits is a true resident of the other contracting state, that the benefits being claimed are available based on a purposive approach to the interpretation of the particular treaty provisions in issue and, where the result obtained is not consistent with the scheme of the particular treaty, the CRA will consider the application of the GAAR. In our view, the MIL decision does not stand for the general proposition that treaty shopping is immune from the scrutiny of the GAAR but only that, on the facts of that case (as determined by the Tax Court Judge), there was no support for the argument that the tax benefit obtained by MIL was an abuse or misuse of any of the provisions of the Act or the *Canada-Luxembourg Income Tax Convention*.

2008 STEP National Conference
Question 12 – Third-Party Civil Penalties

Can you provide an update on whether any assessments have been issued under section 163.2 for third-party civil penalties?

Response

As of April 21, 2008, the CRA has assessed third party penalties in respect of 12 cases. While six of these have filed notice of objections in respect of the penalty, none of these cases has proceeded to the Tax Court of Canada as of yet. Of the 12 cases, two penalties were imposed for misrepresentation in tax planning arrangements and ten were imposed for participating in a misrepresentation. Also, of the 12 cases, 2 relate to an offensive donation arrangement, 6 relate to unsupported or fictitious expenses, 3 relate to deceptive or fictitious journal entries and 1 relates to offensive tax planning.

We are aware that tax professionals are concerned that the CRA might apply the penalties to honest mistakes, oversights or differences of interpretations where there is bona fide uncertainty as to the status of the law. Information Circular 01-1, *Third-Party Civil Penalties*, outlines the CRA's guidelines and processes for applying the third-party civil penalties and includes examples of situations where the CRA believes the penalty should not be applied as well examples of where the penalties should be applied. The auditor must complete a penalty report in every case where the penalty is proposed. The report sets out the criteria being considered in each case recommending a penalty, including any information or explanations from the third party that may mitigate or counter imposition of the penalty. The penalty report will be available on request at the objection stage.

The CRA strictly controls the application of the penalties. To this end, the CRA established the Third-Party Penalty Review Committee. The Committee is comprised of senior representatives from the CRA and from the departments of Finance and Justice.

2008 STEP National Conference
Question 13 - RRSP Frauds and Strips

Can you provide an update on CRA's assessment policy on RRSP frauds and strips? What relief is available for individuals who have lost their RRSPs to fraudulent promoters but who are still being assessed under subsection 146? Is it appropriate for such individuals to be penalized twice - once on the loss of their savings, and subsequently on a cash tax bill on phantom value?

Response

Assessment Policy

Our reassessment policy has always been to reassess the annuitants who partake in these schemes. Where a non-qualified investment has been acquired by a trust, the fair market value of the non-qualified investment at the time it was acquired shall be included in the annuitant's income pursuant to subsection 146(10). In situations where a trust governed by an RRSP acquires property for consideration that is greater than the fair market value of the property at time of acquisition, the difference between the fair market value and the consideration is included in the annuitant's income under subsection 146(9).

Furthermore, CRA is now taking an aggressive stance against the promoters and accommodators (lawyers, accountants, valuators) whose actions and documents give legitimacy to the schemes in the eyes of the taxpayers. We are now considering applying third party civil penalties, as defined in section 163.2 against these parties who facilitate the RRSP Strip schemes.

Relief Available

If the RRSP subsequently disposes of a property that was a non-qualified investment when it was acquired, subsection 146(6) allows as a deduction in computing the income of the annuitant for the year of disposition an amount equal to the lesser of the amount previously included in income at the time the property was acquired pursuant to subsection 146(10), and the proceeds of its disposition.

To the extent there is a loss on the disposition of the property by the trust, such loss is a loss of the RRSP trust and not the annuitant.

Other

CRA has been proactive in exposing the potential downfalls of these schemes to the general public. Tax alerts have been prepared warning taxpayers of the consequences they face by participating in these schemes, including the loss of retirement savings and the reassessment action by the CRA. The CRA has also met with Trustees to have them increase their diligence and adopt policies that will guard against these RRSP strip arrangements.

2008 STEP National Conference
Question 14 -Archived and Cancelled Bulletins

The Canada Revenue Agency now 'archives' Interpretation Bulletins that are used infrequently. The result is that these archived Interpretation Bulletins are no longer updated and no longer appear to be available on the CRA's website. Although the interpretations and positions reflected in Interpretation Bulletins do not bind the CRA, in our experience taxpayers and advisors do take guidance from and place some reliance on Interpretation Bulletins when analyzing and interpreting the law.

Archived Interpretation Bulletins are still an important resource for taxpayers and their advisors. For example, IT-374, *Meaning of "Settlor"* has been archived. In other cases, Interpretation Bulletins are cancelled.

a) Can you provide any update as to whether the CRA is reconsidering its position with respect to updating Interpretation Bulletins?
b) What in your view is the status of an archived Interpretation Bulletin? How is this different from a cancelled Interpretation Bulletin?
c) What guidance can you provide our members as to steps they or their clients should take in confirming whether a position in an archived bulletin still reflects the CRA's current position?

Response

a) The Income Tax Rulings Directorate is responsible for maintaining Interpretation Bulletins. We are currently in the process of recruiting tax professionals to fill the many vacant positions within the Directorate. In the interim, we do not have the resources to maintain all of the Interpretation Bulletins that require attention. We currently have five revised Interpretation Bulletins circulating for approval. It is apparent that the other areas of the CRA, the Department of Finance and the Department of Justice are equally understaffed and prioritizing workloads because the circulation process is taking a very long time to complete.

b) An Interpretation Bulletin is archived when it has not been updated for some time and only some of the positions expressed therein continue to be relevant. The decision to archive a bulletin is based, in part, on the number of times the electronic copy of the bulletin has been accessed on the CRA website. A cancelled Interpretation Bulletin no longer reflects the CRA's views and should not be relied on.

c) Members who want to rely on positions expressed in archived Interpretation Bulletins are urged to contact us, preferably in writing, to determine if the specific positions still reflect CRA's views. The reason we suggest that the request be in writing is that the rulings officer who is likely to be answering your phone call will typically not have sufficient time to fully research whether there has been any jurisprudence or other event that would result in a change in position, nor are the responses to telephone calls subject to the same review process as our written enquiries. As a result, with a telephone call, the best that we can say is that the particular officer answering the call is not aware of any change in position – which does not necessarily mean that there has not been a change in position or that the existing position would necessarily apply in all situations.

2008 STEP National Conference
Question 15 – Assessing Policy following La Survivance

What is CRA's assessing policy in respect of situations identical to that found in the case of La Survivance (2007 DTC 5096)? Will CRA allow a designation to be made under subsection 256(9)?

Response

In response to Question 19 of the 2007 STEP Conference, the CRA stated that the presumption in subsection 256(9) 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 the transaction, applies for all purposes of the Act. The CRA accepts the Federal Court of Appeal's conclusions in the case of La Survivance in regard to the application of the presumption in subsection 256(9).

CRA did not seek leave to appeal of this decision before the Supreme Court of Canada on the grounds that the decision did not raise an issue of national impact.

However, there appears to be a technical argument that was not considered by the Court, regarding the concept of "control in fact" under subsection 256(5.1). CRA is of the opinion that the corporation, La Survivance "controlled directly or indirectly in any manner whatever" the corporation, Les Clairvoyants until such time as it divested itself of the shares in Les Clairvoyants, notwithstanding the presumption in subsection 256(9). Based on this argument, Les Clairvoyants would not have been a Canadian-controlled private corporation and as a consequence, La Survivance would not have been allowed to claim a business investment loss on the disposition of the shares of Les Clairvoyants.

The CRA plans to assess cases similar to La Survivance in order to disallow any business investment loss claimed.

If unintended tax consequences are caused by the application of subsection 256(9), consideration should be given to electing out of subsection 256(9). If the time limit for making an election has passed, the CRA will consider the request for a late-filed election under section 600 of the Regulations on a case-by-case basis.

2008 STEP National Conference
Question 16 – Fifth Protocol Issues

The term “fiscally transparent” is not defined in the Fifth Protocol signed on September 21, 2007 amending the *Canada-U.S. Income Tax Convention*.

How does the CRA interpret the term “fiscally transparent”?

Response

The CRA is of the view that an entity is “fiscally transparent” if the income it earns is taxed at the beneficiary, member, or participant level. Entities that are subject to tax, but with respect to which tax may be relieved under an integrated system, are not considered “fiscally transparent”.

Entities that are fiscally transparent for US tax law purposes include limited liability companies that do not check the box.

Entities that are fiscally transparent for Canadian tax law purposes include partnerships. A trust is generally not disregarded for Canadian tax purposes and would thus not be considered to be an entity that is “fiscally transparent”. A trust that meets the conditions set out in the exception to subsection 104(1), a trust in which the trustee can reasonably be considered to act as agent for all the beneficiaries with respect to all the dealings with all of the trust’s property and is not one of the trusts listed in (a) to (e.1) of the definition of trust in subsection 108(1), will be ignored for Canadian tax purposes and will be considered a fiscally transparent entity.

2008 STEP National Conference
Question 17 – Fifth Protocol Issues

For purposes of applying the Limitation of Benefits Provision of the *Canada-U.S. Income Tax Convention*, as amended by the Fifth Protocol will Canada look through limited liability companies and other entities that are fiscally transparent for US purposes, in applying paragraphs 2(d) and (e) of the definition of “qualifying person” of Article XXIX A?

Response

The principles of new paragraph 6 of Article IV of the Treaty will be taken into account by the CRA when applying the ownership and base erosion provisions of Article XXIX A of the *Canada-U.S. Income Tax Convention*. Therefore, the CRA will “look through” an entity that is viewed as fiscally transparent under the domestic laws of the residence State (other than entities that are resident in the source State) when applying the ownership/base erosion test in paragraphs 2(d) and 2(e) of the definition of “qualifying person” of Article XXIX A of the *Canada-U.S. Income Tax Convention*. The CRA recommended that the Technical Explanation to the Fifth Protocol reflect this interpretation.

For example, assume that USCo, a company incorporated in the United States, wishes to obtain treaty benefits in respect of Canadian source income it receives. USCo is owned by USLLC, an entity that is treated as fiscally transparent in the United States. USLLC is owned by a US resident individual. Since the United States (i.e the resident State vis-a vis the individual) views the USLLC as fiscally transparent, the US resident individual member of the USLLC shall be regarded as the owner of USCo for purposes of the ownership test. Accordingly, USCo would satisfy the ownership requirement of the ownership/base erosion test. Similarly, deductible payments made to USLLC will be treated as made to the US resident individual.

2008 STEP National Conference
Question 18 – Fifth Protocol Issues

It appears that the current *Canada-U.S. Income Tax Convention* provides access to treaty benefits for US partnerships that are treated as corporations under the Internal Revenue Code such that they are fully subject to US tax on worldwide income. Article III(1)(f) of the *Canada-U.S. Income Tax Convention* provides that, unless the context otherwise requires, the term 'company' means any body corporate or any entity that is treated as a body corporate. Accordingly, it appears that a US partnership which is treated as a corporation for US tax purposes falls within the definition of a resident of the US within the meaning of paragraph 1 of Article IV of the *Canada-U.S. Income Tax Convention* because it is a person who, under the laws of the US, is liable to tax in the US by reason of its "domicile, residence, citizenship, place of management, place of incorporation, or any other criterion of a similar nature". Does the CRA look to the partners of such partnerships as the taxpayers in respect of amounts earned or realized by such partnership, rendering useless the treatment of the partnership as a resident of the US for the *Canada-U.S. Income Tax Convention*?

Response

It is our understanding that a US Partnership which "checks the box" will be taxable as a US domestic C corporation and would be liable to US tax on its worldwide income. Accordingly, we agree that unless paragraph 6.2 of the *Income Tax Conventions Interpretation Act* has application, a US Partnership that is treated for the purposes of the Internal Revenue Code as a corporation would be treated as a resident of the US pursuant to paragraph 1 of Article IV of the *Canada-U.S. Income Tax Convention*. Consequently, provided that the US Partnership is a "qualifying person" as defined in Article XXIX A (the Limitation of Benefits Provision) of the *Canada-U.S. Income Tax Convention*, the partners can claim treaty benefits based on the US Partnership's eligibility for such benefits under the *Canada-U.S. Income Tax Convention*.